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Responding to the Subprime Mess: The New Regulatory Landscape

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ARTICLES

RESPONDING TO THE SUBPRIME MESS: THE NEW REGULATORY LANDSCAPE

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ABSTRACT

An era of unregulated financial markets has resulted in an unprecedented global financial disaster. The world's largest central banks and governments are scrambling in uncharted waters to avoid a complete meltdown. Trillions of dollars have been allocated towards financial recovery in the United States alone.

How did we get to this point? The unlikely culprit was residential mortgages in the U.S. Regulatory bodies took no action as irresponsibility and greed fueled this market's rapid growth. One of the great financial bubbles was created. Financial instruments were created, given an imprimatur by rating agencies, and sold the world over. These seemingly secure investments, backed by mortgages on residences in the United States, were purchased by millions of unwary and sophisticated investors on an unparalleled international scale. The investment banks, anxious to ride a wave of profitability, created more and riskier investments as the bubble inflated. Part II of this Article describes the mortgage landscape which predated the collapse.

In 2006, the housing market peaked and began its crash, bringing with it all of the purchasers of the mortgage backed financial instruments.

All the players in the residential housing market were devastated. Homeowners lost their homes. Mortgage lenders disappeared. Investment banks either went out of business, or merely survived

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thanks to government infusions of cash. Investors in some mortgage backed securities lost virtually all the value of their investment. And stock markets around the world crashed with a resounding thud, wiping out vast amounts of wealth.

How did this happen? Where were the regulators? What are the weaknesses in our residential mortgage funding system?

Part III of this Article analyzes the mortgage market, its weaknesses, and its regulatory scheme. The causes of the problem – namely irresponsible borrowers, greedy lenders, unresponsive regulators, the overzealous mortgage backed securities market, the rush by foreign investors to place money in U.S. investments, the irresponsibility of the credit rating agencies, and the collusion of appraisers – are discussed and scrutinized.

Part IV breaks down the new regulations and legislation enacted in the wake of the financial meltdown. Part V examines Fannie Mae and Freddie Mac, their ultimate decline, and resulting takeover by the federal government. Part VI discusses and analyzes the various lawsuits which have arisen from the mortgage meltdown.

Finally, Part VII attempts to specify weaknesses in the residential mortgage funding system, and to propose elements which must be addressed in creating a more stable, yet responsive mortgage market in the future.

I. INTRODUCTION

The last year has produced a debacle of worldwide proportions in the residential mortgage market. An orgy of lending has collapsed. A few years ago, it would have been preposterous to believe that the real estate market in the United States could have such a significant impact on world financial markets. As the real estate bubble inflated and creative mortgage methods were invented, all proven rules were ignored. The questions to ask are: Where were the regulators? Where was the legislature? It had become apparent as early as in 2004 that consumers were getting mortgages which made no rational sense.¹ No one,

1. Erick Bergquist, *Identifying Soft Spots in Fight Against Fraud*, AM. BANKER, Sept. 27, 2004, at 6; Mike Nixon, *Federal Agencies Target Real Estate Lending Fraud*, ST. LOUIS DAILY REC., Oct. 1, 2004; Interview by Gerri Willis with Marianne McCarty,

however, denied mortgages to these consumers. It is time to examine the wreckage and attempt to learn the lessons needed to prevent such a crisis from recurring in the future.

As the suckling was being nursed into the leviathan, a new breed of people calling themselves mortgage brokers were driving the feeding frenzy in order to generate outsized fees. Consumers, ignoring basic financial advice, were entering into mortgages they simply could not repay. Everyone seemed to think that real estate prices would rise forever.

For its part, Wall Street was creating new financial vehicles called mortgage-backed securities (“MBSs”) at a frightening pace.² These MBSs were packaged, securitized, rated by credit rating agencies (“CRAs”) and sold to investors as secure investments. Investors seeking higher returns in the U.S. and abroad were eagerly buying these high-yielding mortgage-backed securities, thereby providing increased funding for new mortgages. Appraisers, driven by their clients to appraise properties to support inflated mortgages, were apparently willing to ignore their own rules to meet the growing pace of mortgage applications.³ Arguably the most important players, the Federal Reserve Board and the Securities and Exchange Commission (“SEC”), did nothing.

Mortgage Bankers Association, & Jean Chatzky, on CNNfn Open House (Sept. 20, 2004).

2. Joseph R. Mason & Joshua Rosner, *How Resilient Are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions?* (Feb. 15, 2007) (forthcoming) (manuscript at 27, available at http://www.hudson.org/files/publications/Mason_RosnerFeb15Event.pdf) (illustrating, in Figure 13, the rise in annual issuance of CDOs from nearly zero in 1995 to over \$500 billion in 2006); George Anders, *Easy Money: A Mortgage Salesman's Pitch*, WALL ST. J., July 20, 2005, at A1. Anders quotes Benchmark Lending Group Inc. founder N. Bernard “Barney” Aldridge scoffing at people who pay down their mortgages month by month, as “just a way of transferring money to your heirs,” instead arguing, “I’d rather make smaller payments and have the money myself.” Expanding loan volumes allowed subprime creditor Benchmark Lending Group Inc. to double its loan volume to \$900 million (projected as of publishing date) between 2004 and 2005. Benchmark did most of its business by phone, only advertising briskly on AM radio during the height of the housing boom in 2005. *Id.*

3. Complaint at 8-9, *People v. First Am. Corp.*, 2008 U.S. Dist. LEXIS 51790 (S.D.N.Y. 2008) (No. 07 Civ. 10397), available at http://www.oag.state.ny.us/media_center/2007/nov/EA%20Complaint.pdf; Complaint at 11, *Koesterer v. Wash. Mut., Inc.*, No. 2:08-Civ-00387 (W.D. Wash. Nov. 5, 2007), available at http://securities.stanford.edu/1038/WM_01/2007115_f01c_0709801.pdf; Complaint at 12, *Wertz v. Wash. Mut. Bank*, No. 2:2008-Civ-00317 (Super. Ct. Cal. Jan. 10, 2008), available at http://appraisalnewsonline.typepad.com/appraisal_news_for_real_e/files/WertzPrimarySuit.p

The Federal Reserve Board was empowered by Congress in 1994 to regulate mortgage issuers,⁴ but chose instead to watch from the sidelines while a bubble was created.⁵ When a bubble is forming and prices are rising, as in a Ponzi scheme, nobody gets hurt. Then, as the bubble accelerates, there is the necessary reckoning – the collapse of prices. We have all heard the experts opining that real estate prices in the U.S. never decline.⁶ New rationales were developed to describe why the

df; Petition from Concerned Real Estate Appraisers From Across America to Ben Henson, Executive Dir., Appraisal Subcomm., Fed. Fin. Insts. Examination Council, *available at* <http://appraiserspetition.com>; Lew Sichelman, *Most Fraud Charges Not Investigated*, REALTY TIMES, Oct. 18, 2006, http://realtytimes.com/printtrpages/20061018_fraudcharges.htm; Sarah Max, *Appraisal Fraud: Your Home at Risk*, CNNMONEY.COM, June 2, 2005, http://money.cnn.com/2005/05/23/real_estate/financing/appraisalfraud/index.htm; Posting of Vernon Martin to Appraisers Forum, <http://appraisersforum.com/showthread.php?t=141764> (July 14, 2008, 01:41 EST).

4. Home Ownership and Equity Protection Act of 1994, 15 U.S.C. § 1601 (1994).

5. Interagency Guidance on Nontraditional Mortgage Products, 70 Fed. Reg. 77,249, 77251 (Dec. 29, 2005), *available at* <http://www.dallasfed.org/banking/notices/2006/not0601.pdf> (“Nontraditional mortgage loan products are more complex than traditional fixed rate products and adjustable rate products and present greater risks of payment shock and negative amortization. Institutions should ensure that consumers are provided clear and balanced information about the relative benefits and risks of these products at a time that will help consumers’ decision-making processes.”); COMPTROLLER OF THE CURRENCY, ADM’R OF NAT’L BANKS, ASSET SECURITIZATION: COMPTROLLER’S HANDBOOK 33 (Nov. 1997), *available at* <http://www.occ.treas.gov/handbook/assetsec.pdf> (noting that “rising delinquencies and charge-offs, inaccurate investor reporting, and bad publicity, have occurred in the later stages of the transaction. The bank should supervise and monitor a transaction for the duration of the institution’s involvement.”); *see also id.* at 40 (noting “[b]ecause originating banks absorb most of the expected losses from both on balance-sheet and securitized pools, sound underwriting standards and practices remain the best overall protection against excessive credit exposure.”).

6. *See, e.g., The Economic Outlook: Hearing Before J. Econ. Comm.*, 109th Cong. (2005) (testimony of Alan Greenspan, Chairman, Bd. of Governors, Fed. Reserve Sys., 1987-2006), *available at* <http://www.federalreserve.gov/boarddocs/testimony/2005/200506092/default.htm> (testifying before Congress in 2005, Greenspan said: “Although a ‘bubble’ in home prices for the nation as a whole does not appear likely, there do appear to be, at a minimum, signs of froth in some local markets where home prices seem to have risen to unsustainable levels.”); Alan Greenspan, Chairman, Fed. Reserve Bd., Remarks Before the Conference on Housing, Mortgage Finance, and the Macroeconomy (May 19, 2005) (transcript available at <http://www.federalreserve.gov/boarddocs/speeches/2005/20050519/default.htm>) (speaking before an audience of housing bankers, Greenspan said: “In a market system, lenders and investors typically monitor and discipline the activities, including leverage, of their counterparties to assure

increases in home values were sustainable. This is a tale of greed and irresponsibility. A confluence of regulatory neglect, a deviation from proven standards and the aggressive development of new financial markets collided in epochal financial wreckage. People got hurt financially and multiple corporations were destroyed or brought to their knees.⁷ Inevitably and expectedly, lawsuits follow financial wreckage and the legal fights are assured to last for many years. Prospective plaintiffs face an uphill battle, as many of the entities driving the problem mortgages have already ceased to exist or sought bankruptcy protection.⁸ People need to learn from this event, and make certain they do not fall into these traps in the future.

Ultimately, as in any financial bubble, risks were improperly evaluated. The lack of responsibility for risky investments did not rest with the decision makers. Home buyers, relying upon rising prices, entered into mortgages that they were ill equipped to pay. Mortgage banks, because they did not retain ownership of the mortgages, looked only to maximize the profits to be made from the mortgage transaction. Investment banks, a vast majority of them content to offload the risk associated with the mortgage investments, were packaging the mortgages and selling them forward with the imprimatur of ratings agencies, which failed to accurately convey the risks associated with these investments. The investment banks even offered financing to investors to buy the flawed investment bundles in an attempt to leverage their own balance sheets. The CRAs, either through negligence or in blind pursuit of profits, issued deeply flawed analyses of the risks involved in buying the securitized instruments.⁹ Investors, reassured by inaccurate credit

themselves that these entities are financially sound.”); Neil Barsky, *What Housing Bubble?*, WALL ST. J., July 28, 2005, at A10 (arguing “[o]ur strong housing market is a function of myriad factors with real economic underpinnings: low interest rates, local job growth, the emotional attachment one has for one’s home, one’s view of one’s future earning-power, and parental contributions, all have done their part to contribute to rising home prices”); Greg Ip, *Housing Prices Aren’t Fed Target, Greenspan Says*, WALL ST. J., July 19, 2005, at A2; Ruth Simon, *Mortgage Lenders Loosen Standards*, WALL ST. J., July 26, 2005, at D1.

7. David Evans, *Banks on the Edge*, BLOOMBERG, Nov. 2008, at ¶ 8, http://www.bloomberg.com/news/marketsmag/mm_1108_story1.html (reflecting on the worst wave of bank failures since 1992.).

8. Scott Bertschi, *Courts Will Dilute Liability Among Participants in Subprime Mortgages*, in FIRST FOCUS: THE SUBPRIME CRISIS 73, 74 (Skupien ed., Thomson West 2008).

9. Roger Lowenstein, *Triple-A Failure*, N.Y. TIMES MAG., Apr. 27, 2008, at 36

ratings and lured by attractive yields, bought these instruments even if they did not understand them.¹⁰

As in the aftermath of all bubbles, the value of these investments quickly eroded. The price was paid by most, but not all, of the parties involved. Home buyers who defaulted on their mortgages lost the fees charged in the mortgage transaction, as well as their equity in the property, if they ever had any. Investors lost value on their investments. Investment banks lost tremendous sums holding and financing the mortgage securities. The mortgage brokers, however, made huge profits from selling the defective loans, and then went out of business.¹¹ The CRAs also pocketed significant fees from issuing defective ratings

(describing ratings agencies as “a central culprit in the mortgage bust”); Aaron Lucchetti, *Rating Game: As Housing Boomed, Moody’s Opened Up*, WALL ST. J., Apr. 11, 2008, at A1 (quoting former Moody’s analyst Mark Froeba as saying, “[a] palpable erosion of institutional support for rating analysis that threatened [Moody’s] market share” during the credit boom”).

10. See, e.g., *Aon Fin. Prods. v. Societe Generale*, 476 F.3d 90, 102 (2d Cir. 2007) (holding a credit default swap (“CDS”) agreement Aon purchased from Societe Generale (“SG”) – to reduce Aon’s own risk exposure to a CDS Aon issued to Bear Stearns (“BS”) to protect BS from a default by a Philippine Government agency (“GSIS”), which issued BS a surety bond securing a loan BS made to a developer of a condominium complex in the Philippines – did not require SG to pay Aon the CDS benefit because neither the underlying default nor GSIS’s failure to honor its obligation to BS constituted a Failure to Pay under the Aon/SG CDS contract, even though Aon was required to pay BS a benefit on the Aon/BS CDS it sought to protect itself against through the Aon/SG CDS); John P. Doherty & Richard F. Hans, *The Changing Landscape of Subprime Litigation*, in 13(16) ANDREWS SEC. LITIG. & REG. 2, 4-5 (2007) (citing Complaint at 11-12, *MetroPCS Commc’ns v. Merrill Lynch & Co.* (Tex. Dist. Ct. Oct. 18, 2007) (No. 07-12430) (alleging broker knowingly sold client CDOs which fell outside the company’s stated investment criteria of low-risk, capital preservation and liquidity)); JOE MORGAN, HEAD OF PORTFOLIO MGMT., & ADAM DEAN, PRESIDENT, SVB FINANCIAL GROUP, AUCTION RATE SECURITIES (Feb. 21, 2008), available at <http://www.svbassetmanagement.com/pdfs/AuctionRateSecurities0208.pdf>.

11. Kara Scannell & Phred Dvorak, *The Fannie/Freddie Takeover: Pay Packages for CEOs Likely to Spur Scrutiny*, WALL ST. J., Sept. 9, 2008, at A21 (Departing Freddie Mac CEO Richard Syron will walk away with at least \$5 million and may be entitled to an additional \$8.8 million to compensate for forfeiting recent equity grants, while Fannie Mae’s Daniel Mudd is entitled to an estimated \$3.2 million in pension. Both were forced out when the firms were nationalized on Sept. 7, 2008.); see also Charles Duhigg, *Pressured to Take More Risk, Fannie Reached Tipping Point*, N.Y. TIMES, Oct. 5, 2008, at A1 (noting Fannie’s Mudd lost millions of dollars as the company’s stock declined, had his severance revoked after the company was seized and continues to look for new work).

before the market imploded.¹² Finally, after the horse has left the barn, the federal government, by legislation and by various agencies, has reacted to the disaster and issued a slew of new regulations.¹³ In order to avoid these problems in the future, and the massively higher costs associated with reactive rather than preemptive measures, it is imperative that we look to the root causes of the problems leading to the financial debacle.

The lack of responsibility in the proper places caused significant dislocations in our financial markets and caused significant pain to home buyers. This Article will detail the causes of the mortgage market collapse, analyze the federal government's responses and finally discuss how the U.S. is to arise out of this mess, and what the world will look like when it does. Part II of this Article will provide a landscape of the U.S. home mortgage market as it once was. The rules are changing; a new mortgage market is being created. For the time being, subprime mortgages have disappeared. If they ever return, the regulatory scheme will be very different.

II. THE OLD MORTGAGE LANDSCAPE

In the recent mortgage market, mortgages have three broad credit quality categories. The most prevalent type of residential mortgage is the "conforming" mortgage.¹⁴ Mortgages made to people who had less

12. See Lucchetti, *supra* note 9 (noting Moody's share price quintupled during the boom as profits rose 375% in six years); Moody's Co., Annual Report (Form 10-K) (SEC File 1-14037), at 14 (Mar. 1, 2007) (reporting net income of \$753.9 million in 2006, nearly double the \$363.9 million Moody's earned in 2003).

13. See, e.g., Truth in Lending Act, 73 Fed. Reg. 44,522-01, 44,529-31 (July 30, 2008). Amendments to Regulation Z were issued in proposed form on Dec. 17, 2007 and adopted in final form on July 16, 2008. If these regulations had been issued a few years earlier, they could have provided a significant restraint on poor lending practices. For a detailed analysis of new federal regulations in response to the subprime mortgage meltdown, see *infra* Part V.

14. Of the loans outstanding in the United States, prime fixed rate loans accounted for 65% of the market, and prime ARM for 15%. Press Release, Mortgage Bankers Ass'n, Delinquencies and Foreclosures Increase in Latest MBA National Delinquency Survey (June 5, 2008), available at <http://www.mbaa.org/NewsandMedia/PressCenter/62936.htm>; see also Mike Fratantoni, *Characteristics of Outstanding Residential Mortgage Debt: 2006*, MBA RESEARCH: DATA NOTES (Mortgage Bankers Ass'n, Washington, D.C.), Jan. 2007, at 3 chart 10, available at http://www.mortgagebankers.org/files/Bulletin/InternalResource/47210_DataNoteCharacteristicsofOutstandingResidentialMortgageDebtfor2006.pdf. As of July 2008, Fannie Mae and Freddie Mac insured

than stellar credit or to people who would have little or no equity in the property are called subprime mortgages.¹⁵ “Alt-A” mortgages involve risks somewhere between these two categories.¹⁶ In addition, many other mortgages were obtained by predatory lending. Many others also carry characteristics of adjustable, not fixed, rates.

A. Conforming Mortgages

Conforming mortgages are so named because they meet the standards required for purchase by Federal National Mortgage Association (“Fannie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”).¹⁷ Conforming designation only applies to mortgages

70 % of all new mortgages. Henry M. Paulson, Jr., Sec’y of the Treasury, Remarks on U.S. Housing Market Before FDIC’s Forum on Mortgage Lending to Low and Moderate Income Households (July 8, 2008) (transcript available at <http://www.treasury.gov/press/releases/hp1070.htm>).

15. Mark Doms et al., *House Prices and Subprime Mortgage Delinquencies*, 2007-14 FRBSF ECONOMIC LETTER (Fed. Reserve Bank of San Francisco, San Francisco, CA), June 8, 2007, at ¶ 3, available at <http://www.frbsf.org/publications/economics/letter/2007/el2007-14.pdf> (designating borrowers with low credit scores, such as FICO score below 620, with little credit history, or with other types of observable credit impairment as “subprime”). In 2005, the typical “subprime” loan was characterized by an adjustable interest rate (93%) and required borrowers with an average FICO score of 650 to provide little to no documentation of their income (51%). A significant minority were interest only loans (38%) and/or mortgaged non-owner occupied [read: investment] property (9%). Amy Cutts & William A. Merrill, *Interventions in Mortgage Default: Policies and Practices to Prevent Home Loss and Lower Costs* 48, tbl.3 (Freddie Mac, Working Paper No. 08-01, 2008), available at http://www.freddie-mac.com/news/pdf/interventions_in_mortgage_default.pdf.

16. In 2005, the typical “Alt-A” loan was characterized by an adjustable interest rate (72%), negative amortization (67%) and required borrowers with an average FICO score of 720 to provide little or no documentation of their income (74%). See Cutts & Merrill, *supra* note 15, at 48.

17. Conforming mortgages eligible for purchase by Fannie Mae and Freddie Mac are statutorily defined, at 12 U.S.C. § 1717(b)(2) (2008) and 12 U.S.C. § 1454(a)(2) (2008), as loans secured by 1-4-family dwelling units with a principal balance no greater than 80% of the property value at the time of purchase (with limited exceptions, including buyers who purchase private mortgage insurance (“PMI”)) up to 125 % of the median 1-family house price in the area, Economic Stimulus Act of 2008, Pub. L. No. 110-185, 122 Stat. 613, § 201(a)(1)-(2) (1998), or \$729,750 (1.75 times the 2008 conforming loan limit of \$417,000), OFFICE OF FED. HOUS. ENTER., METROPOLITAN STATISTICAL AREAS, MICROPOLITAN STATISTICAL AREAS AND RURAL COUNTIES WITH NEW LOAN LIMITS (2008) [hereinafter MICROPOLITAN STATISTICAL AREAS], available at http://www.ofheo.gov/media/hpi/AREA_LIST_5_2008.pdf. See Announcement 08-

with an initial principal amount of less than \$417,000.¹⁸ Conforming mortgages are also required to meet these additional criteria:

- (1) The borrower's income must be verified (usually with wage statements and income tax returns);
- (2) The borrower must have good credit (a credit score of 720 or higher);
- (3) The proposed mortgage principal must be less than 80% of the appraised value of the home (a loan-to-value ratio of 80% or less);
- (4) The proposed monthly mortgage payment plus the monthly real estate tax bill must not exceed 28% of the borrower's gross monthly income;
- (5) The borrower may not have other excessive outstanding loans or debt; and
- (6) Total debt payments, including this mortgage, do not exceed 35% of the borrower's gross monthly income.¹⁹

Conforming loans currently remain a safe investment, with less than 1% of conforming mortgages in default.²⁰

11, FannieMae, Jumbo-Conforming Mortgage Loans – Expanded Eligibility and Products 9-11, attachment 2 (May 16, 2008), available at <https://www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2008/0811.pdf> [hereinafter FannieMae Jumbo Loan Announcement].

18. Fannie Mae and Freddie Mac set standards for conforming loans. The conforming loan maximum was increased from \$417,000 to \$729,750 until December 31, 2008 as a mitigation of the poor housing market. David M. Dickson, *Jumbo Loan Limits*, WASH. TIMES, Dec. 9, 2008, at A08. Mortgages in excess of the conforming loan limit are called “jumbo” mortgages. *Id.*

19. FANNIEMAE, SINGLE-FAMILY MBS PROSPECTUS 50-53 (Apr. 1, 2008), available at http://www.efanniemae.com/syndicated/documents/mbs/mbspros/SF_April_1_2008.pdf (outlining Fannie Mae's mortgage standards and eligibility guidelines); FannieMae Jumbo Loan Announcement, *supra* note 17; see also 12 U.S.C. § 1717(b)(2); 12 U.S.C. § 1454(a)(2); Economic Stimulus Act of 2008 § 201(a)(1)-(2); MICROPOLITAN STATISTICAL AREAS, *supra* note 17.

20. In the second quarter of 2008, less than 1% of all U.S. home mortgage loans entered foreclosure, but among subprime ARM's, 6.35% entered foreclosure. U.S. DEPT. OF HOUS. & URB. DEV., U.S. HOUSING MARKET CONDITIONS: 2ND QUARTER, 2008, NATIONAL DATA 24 (2008), available at http://www.huduser.org/periodicals/ushmc/summer08/national_data.pdf. Prime mortgage lending remains much less risky than prime lending. While prime fixed rate loans accounted for 65% of all U.S. loans originated, at 19% they account for a comparatively small proportion of U.S. foreclosures. Subprime ARMs, by contract, account for only 6% of U.S. loans origina-

B. Alt-A Mortgages

The second type of mortgage credit category is known as “Alt-A.” In 2006, Alt-A loans made up about 16% of the mortgage loans made that year.²¹ Alt-A loans generally fail to meet the rules for conforming loans, but only by one of the conforming loan requirements.²² For example, the credit score may be below conforming standards, but not to the point of making the mortgage a subprime loan. In 2006, credit scores from 580-700 would have fit in this category.²³ Other reasons could be a lack of income documentation, a borrower with high outstanding credit card debt, or a “jumbo” loan amount. Alternatively, if the mortgage amount exceeds 80% of the value of the home, it would be an Alt-A loan.

Alt-A loans are made at less favorable terms than conforming loans, meaning that an Alt-A borrower will usually pay a higher interest rate and more fees than a conforming borrower.²⁴ Alt-A loans are question-

ted but account for 39% of all foreclosures. Press Release, Mortgage Bankers Ass’n, *supra* note 14.

21. Alt-A loans comprised 13.4% of all originations in 2006. Just three years earlier, in 2003, Alt-A loans made up only 2.2% of the market. David Greenlaw et al., *Leveraged Losses: Lessons from the Mortgage Market Meltdown* 16, exhibit 3.2 (U.S. Monetary Policy Forum Conference Draft, Feb. 9, 2008), available at <http://www.chicagogsb.edu/usmpf/docs/usmpf2008confdraft.pdf>. Interestingly, as single-family originations began falling significantly in the fourth quarter of 2006, Alt-A lending for the year still rose 5.3% to \$400 billion and home equity lending increased nearly 18% to \$430 billion during the same period. *Id.* Non-jumbo, prime conventional mortgage originations fell 9% to \$990 billion in 2006 and represented only 33% of total originations. VALERIE SMITH ET AL., OFFICE OF FED. HOUS. ENTER. OVERSIGHT, MORTGAGE MARKETS AND THE ENTERPRISES IN 2006 8, 11 (June 2007), available at <http://www.ofheo.gov/media/research/MortgageMarkets2006.pdf>.

22. In 2006, Alt-A borrowers had an average credit score of 717. *See, e.g.*, KENNETH TEMKIN ET AL., U.S. DEP’T OF HOUS. & URBAN DEV., SUBPRIME MARKETS, THE ROLE OF GSE’S, AND RISK-BASED PRICING 4 (Mar. 2002) (noting the high percentage of Alt-A borrowers with FICO scores over 720 in 1998); *see* Cutts & Merrill, *supra* note 15, at 48 tbl.3.

23. The Credit Score is the FICO score assigned to a borrower’s credit rating. The score is assigned by Fair Isaac Co. *See* Truth in Lending Act, 73 Fed. Reg. 1672, 1687 (Jan. 9, 2008) (amending 12 C.F.R. § 226.34(a)(4)) (noting limited transparency of prices, products, and originator incentives reduces a borrower’s expected benefit from shopping further for a better option).

24. These are just a couple of factors that may affect an Alt-A borrower to enter default, the recurrence of which would further exacerbate the financial crisis. *See* David Liu & Shumin Li, *Alt-A Credit – The Other Shoe Drops?*, THE MARKETPULSE

able, but are generally expected to perform in the future.²⁵ The default rate of Alt-A loans in 2006 was 4.2%.²⁶

C. Subprime Mortgages

Subprime mortgages are non-conforming mortgages which do not meet the standards for conforming loans by a substantial margin.²⁷ Most subprime mortgages were, in recent years, made with no verification of the borrower's income.²⁸ Many subprime mortgages were given for or close to 100% of the value of the home.²⁹ Many more were obtained by borrowers with the worst credit history, a credit score below 580.³⁰ Remarkably, subprime mortgages grew from \$35 billion in 1995 to \$807 billion in 2005.³¹

(First American LoanPerformance, Inc., San Francisco, C.A.), Dec. 2006, at 8, available at http://www.facorelogic.com/uploadedFiles/Newsroom/Innovations_Newsletter/MPDecember2006DataLowRes.pdf (warning an extended period of flat or declining housing prices might result in up to a 20% increase in cumulative losses on Alt-A debt issues). Mortgage companies and mortgage brokers generally earned a higher fee from lenders when placing a borrower in an Alt-A loan instead of a conforming loan. See, e.g., Gopi Mattel, CellarStone, Inc., Mortgage Broker Commissions and Incentives – A Primer, available at <http://www.qcommission.com/doc/Mortgage-Broker-SalesCommissions-A-Primer-Article.pdf>.

25. See Liu & Li, *supra* note 24, at 6-7.

26. Excluding “pay option” ARM Loans. Mark Goldberg & Jeff Watson, *Performance of U.S. RMBS Alt-A Loans Continues to Deteriorate*, RATINGSDIRECT (Standard & Poor's, New York, N.Y.), June 26, 2007, at 1, available at http://www2.standardandpoors.com/spf/pdf/media/subprime_deteriorate_062607.pdf.

27. It is interesting to note that the word subprime did not come to have this meaning until 1993. See Simon Winchester, *Subprime, Pre-Slime*, N.Y. TIMES, Oct. 20, 2008, at A31.

28. In 2005 and 2006 over half of all subprime loans were made with little to no documentation of the borrowers income. See Cutts & Merrill, *supra* note 15, at 48 tbl.3.

29. At the time of origination 35.9% of subprime loans exceeded 90% of the property's appraised value (LTV ratio). An additional 22.3% were subject to a second lien. See Scott Frame et al., *A Snapshot of Mortgage Conditions with an Emphasis on Subprime Mortgage Performance* 5 tbl.2 (Fed. Res. Bd., Working Paper, Aug. 27, 2008), available at http://federalreserveonline.org/pdf/MF_Knowledge_Snapshot-082708.pdf (prepared for Federal Reserve's Home Mortgage Initiatives coordinating committee).

30. *Id.* (demonstrating that 24.2% of subprime borrowers had a credit score of 580 or lower).

31. *Credit Rating Agencies and the Financial Crisis: Hearing Before the H.*

Subprime borrowers paid significantly higher interest rates and significantly higher fees than conforming or Alt-A borrowers.³² Because many of these borrowers were simply happy to be offered a mortgage, they were willing to accept very onerous terms. It was not unusual to see loans made at a 10-11% annual percentage rate. Mortgage brokers pocketed an additional 0.2% to 0.4% in fees at origination.³³ In addition, many subprime mortgages were made to well-qualified speculators who were avoiding the normal rules in order to highly leverage the purchase of many homes and condominiums in the hope that they could be quickly “flipped” for an easy profit.³⁴ People who could not qualify for conforming loans were given mortgages they likely could not and would not repay. As lending practices became more lax, more loans were made with increasing risk. In 2005, subprime mortgages made up nearly 20% of the mortgage market, compared to

Comm. on Oversight and Government Reform, 110th Cong. 2 (2008) [hereinafter *Hearing*] (statement of Frank L. Raiter, Managing Director and Head of Residential Mortgage Backed Securities Ratings Group, Standard and Poor's, Mar. 1995-Apr. 2005), available at <http://oversight.house.gov/documents/20081022102804.pdf>.

32. For example, 73% of subprime loans included a prepayment penalty with an average penalty of 30 months, Frame et al., *supra* note 29, at 3, while less than 2% of conventional borrowers accept such penalties. *Subprime Lending: Defining the Market and Its Customers: Before the Subcomm. on Housing and Community Opportunity & the Subcomm. on Financial Institutions and Consumer Credit*, 108th Cong. 8-9 (2004) (prepared testimony of Eric Stein, Senior Vice President, Center for Responsible Lending), available at <http://www.responsiblelending.org/pdfs/SteinStatement033004.pdf>. Interest rates on subprime loans average 8.62%; see, e.g., Truth in Lending Act, 73 Fed. Reg. 44,522-01, 44,542 (July 30, 2008); see Frame et al., *supra* note 29 at 5, table 2. Assuming a 30-year subprime purchase loan of \$120,000 with a fixed interest rate of 8.4% (versus the 8% rate the borrower likely would have received without a prepayment penalty), borrowers would pay more than \$2,000 in additional interest over a five-year period if their loan included a prepayment penalty. If held to maturity, borrowers would pay more than \$12,000. KEITH S. ERNST, CTR. FOR RESPONSIBLE LENDING, BORROWERS GAIN NO INTEREST RATE BENEFITS FROM PREPAYMENT PENALTIES ON SUBPRIME MORTGAGES 5 (Jan. 2005), available at http://www.responsiblelending.org/pdfs/rr005-PPP_Interest_Rate-0105.pdf.

33. Subprime mortgage brokers earned commissions from 0.2% to 0.4% of each loan they originate, often earning several hundred thousand dollars per year in the process. See Anders, *supra* note 2. Based on this fee schedule, and the average subprime mortgage principal amount of \$181,347, mortgage brokers earn a fee of between \$363 to \$725 on a typical loan. See Frame et al., *supra* note 29, at 5 tbl.2; see also Gopi Mattel, *supra* note 24.

34. Todd J. Zywicki & Joseph D. Adamson, *The Law & Economics of Subprime Lending*, 80(1) U. COLO. L. REV. 1 (forthcoming Winter 2009).

less than 5% in 2001.³⁵

As of December 31, 2007, 17.4% of subprime loans were seriously delinquent and 47.1% were behind one payment or more according to Federal Reserve Board staff calculations.³⁶ While the majority of these loans will likely avoid default,³⁷ what many people misunderstood was exactly how bad subprime mortgages actually were. For a large number of these mortgages, any rational person could have seen that the borrower could barely, if at all, afford to pay even the initial monthly interest payments on mortgage.

D. Predatory Lending

Another group of mortgages, albeit not exactly a traditional category under the U.S. standards, falls under the description of predatory lending. Predatory lending involved using fraudulent tactics to induce a borrower to enter into a loan.³⁸ Predatory lenders commonly failed to

35. Christopher J. Mayer & Karen Pence, *Subprime Mortgages: What, Where, and to Whom?* 25 fig.1B (Fed. Reserve Bd. Fin. & Econ. Discussion Series, Divs. of Research & Statistics & Monetary Affairs, NBER Working Paper No. 14083, June 2008), available at <http://www.federalreserve.gov/pubs/feds/2008/200829/200829pap.pdf>.

36. Frame et al., *supra* note 29, at 5 tbl.2.

37. The “only variable . . . that contributed substantially to the [subprime delinquency crisis] is the low subsequent house price appreciation for vintage 2006 and 2007 loans, which can explain about a factor of 1.24 and 1.39, respectively, higher-than-average likelihood for a current loan to turn delinquent. Due to geographical heterogeneity in house price changes, some areas have experienced larger-than-average house price declines and therefore have a larger explained increase in delinquency and foreclosure rates.” Yuliya Demyanyk & Otto Van Hemert, *Understanding the Subprime Mortgage Crisis 2* (Working Paper, Dec. 5, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1020396. The combined LTV ratio is believed to be the main determinant of delinquency, because it is the burden of all the debt together that may trigger financial problems for the borrower. *Id.* at 3. When the housing market returns to normal, with moderately appreciating home values, even subprime mortgages should perform. See also Zywicki & Adamson, *supra* note 34, at 25.

38. “Predatory lending depends on the inability of the borrower to understand the loan terms and the obligations associated with them.” Giang Ho & Anthony Pennington-Cross, *Predatory Lending Laws and the Cost of Credit 3* (Research Div., St. Louis Fed. Res., Working Paper No. 2006-022A, Apr. 2006), available at <http://research.stlouisfed.org/wp/2006/2006-022.pdf>. Subprime loans were heavily concentrated in fast-growing parts of the country with considerable new construction, zip codes with more residents in the moderate credit score category and more black and Hispanic residents. Areas with lower income and higher unemployment had more

fully disclose the terms of a loan, which included excessive fees and outrageous interest rates.³⁹ For example, a predatory loan may have had a low, “teaser” interest rate for one month, which then readjusted in the second month to a far higher interest rate. Many of these loans were used as a pretense to fraudulently acquire a person’s home.⁴⁰ It was not unusual for a predatory lender to charge significant portions of the loan principal in upfront fees.⁴¹ Many states have enacted predatory lending laws, but they have proven difficult to enforce, as prosecuting attorneys do not have the resources to find and penalize those who engage in all but the most egregious of these lending practices.⁴²

E. Adjustable Rate Mortgages

Many people have blamed adjustable rate mortgages (“ARMs”) for a significant portion of the subprime mess. These mortgages were part of the problem, but not as much as many people believe. Used correctly, adjustable mortgages are not necessarily evil. As long as the borrower fully understands the terms of the mortgage and plans accordingly, an adjustable rate mortgage can actually be quite useful to the borrower.

ARMs differ from the more usual fixed rate mortgage in that the annual percentage rate (“APR”) charged as interest changes over the period of the loan.⁴³ In order to induce the borrower to enter into the loan,

subprime lending, but these associations are smaller in magnitude. *See* Mayer & Pence, *supra* note 35, at 2. Predatory lenders typically target the poor and the elderly. JAMES H. CARR, SENIOR VICE PRESIDENT, & LOPA KOLLURI, SENIOR CMTY. FIN. CONSULTANT, FANNIE MAE FOUNDATION, PREDATORY LENDING: AN OVERVIEW, FANNIE MAE FOUNDATION 2 (2001).

39. *See* CARR & KOLLURI, *supra* note 38, at 4.

40. *Id.*; *see, e.g.*, Truth in Lending Act, 73 Fed. Reg. 44,522-01, 44,542 (July 30, 2008).

41. *Home Mortgage Disclosure Act Data and FTC Lending Enforcement Before the H. Comm. on Financial Servs., Subcomm. on Oversight and Investigations*, 110th Cong. § IV, pt. A. (2007) (statement of Lydia B. Parnes, Director, Bureau of Consumer Protection, Federal Trade Commission), *available at* <http://www.ftc.gov/os/testimony/P064806hdma.pdf>; *see also* CARR & KOLLURI, *supra* note 38, at 5 (noting the extreme example where a lender flipped a loan 11 times, attaching a 10 percent finance fee each time).

42. Baher Azmy, *Squaring The Predatory Lending Circle: A Case For States as Laboratories of Experimentation*, 57 FLA. L. REV. 295, 301, 359-60 (2005).

43. *See generally* FED. RESERVE BD., CONSUMER HANDBOOK ON ADJUSTABLE-RATE MORTGAGES 6-10, *available at* http://www.federalreserve.gov/pubs/arms/arms_brochure.pdf [hereinafter CONSUMER HANDBOOK].

the introductory rate is typically set artificially low. Then, after an introductory period of typically 5-10 years for conforming loans and 2 years for subprime loans,⁴⁴ the interest rate begins to float and has to be regularly readjusted.⁴⁵ This rate adjustment is based on an index – such as the LIBOR or MTA – plus an additional margin above the rate of the index.⁴⁶

There are two potential traps created by ARMs which impacted borrowers. First, the initial monthly payment may soon become far greater if interest rates rise. The monthly payment, therefore, becomes absolutely dependent on market interest rates, the configuration of which is out of the borrower's control, which makes financial planning difficult. Second, since the low introductory interest rate was used to qualify the borrower for the loan,⁴⁷ it was possible for borrowers to obtain mortgages with monthly payments they could no longer afford after the introductory period. Indeed, this is what happened as borrowers purchased more expensive homes, assuming they would be able to re-finance their ARMs before the introductory period expired.

Although some ARMs are now going into default, the rate of such default is not catastrophic.⁴⁸ More important to the determination of risk

44. In 2007, 35 out of every 100 loans at reset either defaulted or became delinquent within six months of the rate reset. Presentation to the Florida Governor's Florida Home Ownership Promotes the Economy (HOPE) Task Force, *The Subprime Crisis: An Overview* 12, 14-15 (Mar. 3, 2008), available at <http://www.flgov.com/pdfs/20080303presentation.pdf> [hereinafter *The Subprime Crisis: An Overview*]; see also Frame et al., *supra* note 29, at 12-15 (noting the effect of a reset depends on whether the borrower can prepay the loan by either selling the house or refinancing and if they cannot prepay, what happens to the reference index rate).

45. See CONSUMER HANDBOOK, *supra* note 43, at 7-9.

46. See *id.* at 8-9.

47. See Zywicki & Adamson, *supra* note 34, at 25 (arguing higher levels of default and foreclosure on hybrid or adjustable-rate loans reflect selection bias rather than flaws in the loan products themselves). Up to 32 percent of loans with initial teaser rates eventually will default as a result of interest rate reset, but only 7 percent of market-rate adjustable loans will default due to reset. *Id.* at 25 (citing CHRISTOPHER L. CAGAN, FIRST AM. CORE LOGIC, MORTGAGE PAYMENT RESET: THE ISSUE AND THE IMPACT (Mar. 19, 2007), available at http://www.facorelogic.com/uploadedFiles/Newsroom/Studies_and_Briefs/Studies/20070048MortgagePaymentResetStudy_FINAL.pdf). Of subprime loans facing foreclosure, 36 percent are for hybrid loans, fixed-rate loans account for 31 percent, and adjustable-rate loans for 26 percent. *Id.* at 25 (citing James R. Barth et al., *Mortgage Market Turmoil: The Role of Interest-Rate Resets*, SUBPRIME MARKET SERIES (Milken Inst., Santa Monica, C.A.) Dec. 2007).

48. Cumulative loss estimates on short-reset hybrid ARM (2/28 and 3/27) loans are

involved with mortgages is whether the income of the borrower was evaluated. As Part III will explore, mortgages with no income verification are at the greatest risk of default.

III. CAUSES OF THE PROBLEM

The mortgage debacle was driven by purchasers of residential mortgages entering into mortgages which they could not afford.⁴⁹ This ultimately led to mortgage defaults and increased foreclosures. In addition, the mortgages were often made under the flawed assumption that property values would continue to rise substantially and immediately, resulting in mortgages with balances exceeding the values of the properties.⁵⁰ This condition is referred to as being “under water,” or “upside down” on one’s mortgage.⁵¹ In a traditional debt analysis, there are two safety features. First, the borrower should have the proven capability to pay. Second, the secured property should have sufficient value to satisfy the debt. If these conditions are met, defaults on loans are very rare.⁵² Both of these conditions, nevertheless, were ignored, fueling an explosion of defaults.⁵³

As prices declined, people who had borrowed a high percentage of their purchase price had a lesser incentive to struggle to make their

5.25% for 2005 and 6.75% for 2006, with 80% of cumulative loss projections between 1.75% and 8.75% for 2005 and between 3.90% and 11.25% for 2006. Scott Davey & Matthew Keenen, *Revised Default and Loss Curves for U.S. Alt-A RMBS Transactions*, RATINGSDIRECT (Standard & Poor’s, New York, N.Y.), Dec. 19, 2007, at 6, available at <http://www2.standardandpoors.com/spf/pdf/media/Dec%2019%20Alt-A%20methodology.pdf>.

49. The standard for how much total debt and housing expenses certain borrowers can carry rose from 38% to 45% of their income in some markets. See Simon, *supra* note 6.

50. See Demyanyk & Van Hemert, *supra* note 37, at 1-9.

51. David Leonhardt, *Life Preserver for Owners Under Water*, N.Y. TIMES, Oct. 22, 2008, at B1.

52. Two decades of economic buoyancy gave lenders the confidence to believe such security measures were no longer necessary. As former Fed Chairman Alan Greenspan told Congress in October 2008, “[t]he whole intellectual edifice . . . collapsed in the summer of [2007], because the data inputted into the risk management models generally covered only the past two decades, a period of euphoria.” *Hearing, supra* note 31, at 18-19 (statement of Alan Greenspan, Chairman, Bd. of Governors, Fed. Reserve Sys., 1987-2006), available at <http://oversight.house.gov/documents/20081024163819.pdf>; see also *The Subprime Crisis: An Overview, supra* note 44, at 13.

53. See Demyanyk & Van Hemert, *supra* note 37.

payments. If the mortgage had an adjustable rate, the payment was increasing.⁵⁴ The result was defaults and foreclosures of record proportions. Because the properties no longer had sufficient value to repay the mortgage upon a sale in foreclosure, lenders and investors suffered a loss. Because the lender sold the mortgage to a third party, the third party had an asset which had decreased in value.⁵⁵

Although the government stepped in to alleviate the problem, it was already too late. A laissez-faire attitude toward mortgage lending created a feeding frenzy by all parties involved. Borrowers took out loans that went into foreclosure. Lenders made bad mortgages that went into default.⁵⁶ Investment banks pooled mortgages and sold them to investors, leading investors to believe their investments were far more secure than they were. And to make matters come full circle, investment banks also lent money to purchasers of these poor securities, suffering losses when these purchasers could not repay their debts to the banks. The people who made money on these transactions – the so-called mortgage brokers – took their money and are now out of the picture. Many are currently employed in other endeavors. If the government had reacted earlier, or regulated correctly in the first place, most of the losses could have been avoided.

Ultimately, the subprime mortgage crisis is a failure of responsibility at every level: borrowers, lenders, investment banks, appraisers, rating agencies, investors, and undoubtedly, the regulators. In the rush to follow greed at every level, all the normal protections broke down.

54. *See id.*

55. “The foreclosure crises [sic] is basically the result of the decline in prices of homes,” Greenspan told Congress. “[B]efore we had all of the securitization . . . most of the loans were made by savings and loans, when the borrower got into trouble, the holder of the mortgage recognized that if foreclosure occurred that he would lose as well.” *Hearing, supra* note 31, at 133 (statement of Alan Greenspan, Chairman, Bd. of Governors, Fed. Reserve Sys., 1987-2006), available at <http://oversight.house.gov/documents/20081024163819.pdf>.

56. Subprime lenders New Century Financial Corp. and Fremont General Corp. filed for bankruptcy protection in April 2007 and June 2008, respectively. Tiffany Kary, *Fremont Files Bankruptcy After CapitalSource Sale*, BLOOMBERG, June 18, 2008, <http://www.bloomberg.com/apps/news?pid=20601208&sid=aTXnk2vnT0NA&refer=finance>. In 2004, New Century earned \$800.6 million from sale of loans. New Century Financial Corp., Annual Report (Form 10-K), at 55 (Mar. 16, 2006); *see also* Victoria Wagner & John K Bartko, *Subprime Mortgage Lenders: Transition in a Stressed Mortgage Cycle*, RATINGSDIRECT (Standard & Poor’s, New York, N.Y.), Apr. 27, 2007, at pt.6.

A. Mortgage Market Gone Wild

A significant cause of the increase in foreclosures and bad mortgages was the consumer; the person who either did not understand, underestimated or ignored the risks involved in getting a mortgage. There were some instances of sheer fraud in inducing consumers to obtain very poor mortgages, called predatory lending,⁵⁷ but the vast majority of nonperforming loans were simply made to people who could not afford them, and should have been informed of that fact. Many people were caught up in the belief that real estate was an investment that would consistently provide guaranteed returns.⁵⁸ People believed that they could not lose if they bought a home. The government proudly crowed at the increasing percentage of homeownership of U.S. citizens.⁵⁹ In many places the expectation that property would continue to increase in value fueled a frenzy of buying. This belief encouraged people to incur risks well beyond their normal comfort range. It also persuaded some people to engage in risky purchases with the expectation of profits. As people saw their friends make money in real estate, they made copycat decisions to enter this lucrative investment field. Profits earned, of course, lured more people into the real estate market. True home buyers and speculators driven by the dream of easy profits agreed to take on such high closing costs and interest rates that even the most aggressive lenders must have had to pause and to wonder, at least momentarily: 'Is this really happening?' All the while, the unprecedented demand created a juicy flow of cash upon which the mortgage brokers gorged themselves.

Speculators in many of the hottest markets used subprime loans to finance their pursuit of a quick profit.⁶⁰ In some instances, a person

57. See Azmy, *supra* note 42, at 299-300.

58. "Of course, over the past 25 years we have seen numerous real estate busts," argued Neil Barsky, managing partner of Alson Capital Partners, LLC in the summer of 2005 in an op-ed in *The Wall Street Journal*. "What we have never seen in this country is a collapse of home prices without also seeing local economic weakness or significant capacity growth. Absent those factors, housing markets just don't collapse under their own weight. Herewith are some of the myths put forth by the housing bubble Chicken Littles." Neil Barsky, *What Housing Bubble?*, WALL ST. J., July 28, 2005, at A10.

59. Edwin Chen, *Bush, in Pennsylvania, Hails Record Homeownership*, L.A. TIMES, Mar. 16, 2004, at A30. (The home ownership rate in the U.S. rose to a record 68.6%); see also David Streitfeld & Gretchen Morgenson, *Building Flawed American Dreams*, N.Y. TIMES, Oct. 19, 2008, at A1.

60. Zywicki & Adamson, *supra* note 34, at 30.

either made a profit themselves in the rapidly rising real estate market or saw a friend make an easy profit. These speculators would use 100% financed subprime mortgages and buy multiple houses or condominiums and then default on the mortgage when the real estate market turned down. A speculator could obtain these mortgages without income or asset verification. The belief was that the mortgage would be paid off in a short time, when the property was “flipped” for a quick profit. Real estate brokers encouraged these tactics to stimulate their business and directed the buyers to compliant lenders who paid large commissions.⁶¹ In addition, the lack of required documentation induced many people to buy properties for inflated prices and pay off involved parties. They were defrauding the lenders and had no intention of ever repaying the loan.⁶² The ease with which anyone could get large sums of money brought about a large number of fraudulent schemes.⁶³ This speculation helped to drive up prices in the hottest real estate markets and consequently led to their rapid fall when the properties went into default.

*1. A Short Note on the History and Development
of Subprime Mortgages*

Like many ideas which begin with a commendable premise and end with disaster, the evolution of subprime mortgages is sprinkled with abundant good intentions. In the 1970s, the U.S. government embarked upon programs which would encourage home ownership among minority groups. The Community Reinvestment Act, enacted in 1977, required that all banking institutions be evaluated to determine if they were adequately meeting the credit needs of their local community.⁶⁴ This Act did not provide specific criteria for the evaluation, but directed that the evaluation should accommodate the situation and context of each institution. The Act did not require that an institution make high-risk loans. The goal was to encourage minority participation in the

61. Anthony Effinger, *Fear & Foreclosure in Las Vegas*, BLOOMBERG, Dec. 2008, http://www.bloomberg.com/news/marketsmag/mm_1208_story2.html.

62. Ryan Mills, *FBI Arrests Two in Nationwide Real Estate Scam Involving Collier Homes*, NAPLES DAILY NEWS, Oct. 17, 2008, at A1 (noting indictments of people using subprime, non-document loans to obtain mortgages, and to illegally profit from the proceeds).

63. See Eric Lichtblau et al., *F.B.I. Struggling to Handle Wave of Finance Cases*, N.Y. TIMES, Oct. 19, 2008, at A1 (noting that the FBI does not have the resources to pursue the large number of mortgage fraud cases which have arisen since 2004).

64. The Community Reinvestment Act, 12 U.S.C. §§ 2901-08 (1977).

American dream of homeownership.⁶⁵ This goal continued through the Clinton administration and into the George W. Bush years.⁶⁶

Reducing the down payment required of a purchaser and offering mortgages to persons with lower than previous credit standards was intended to broaden the pool of mortgage borrowers; it was believed that by allowing more people into homeownership, household wealth would increase. More people could build equity in their home and could realize an increase in wealth from the rising asset values.⁶⁷ Subprime mortgages were meant to provide an opportunity for homeownership to those who could not previously qualify for a mortgage.⁶⁸ Subprime mortgages were initially concentrated in minority neighborhoods and neighborhoods with weaker economic conditions.⁶⁹

From the onset of the subprime mortgage lending program, it was recognized that default rates would be higher than those experienced in the conforming mortgage market. In fact, it was expected that the default rates would be much higher.⁷⁰ Delinquency rates on subprime mortgages in 2002 were reported to be 5.5 times higher than for prime mortgages.⁷¹ The higher fees and higher interest rates charged on subprime mortgage loans were thought to adequately compensate lenders for the increased risk. The subprime lenders set the interest rates based upon loan grades. The lower the grade, the higher the interest rate charged. The grades were based upon the borrower's credit score and

65. See generally Amy E. Hillier, *Spatial Analysis of Historical Redlining: A Methodological Exploration*, 14(1) J. HOUSING RES. 137-67 (Nov. 2003), available at http://repository.upenn.edu/cgi/viewcontent.cgi?article=1008&context=cplan_papers.

66. See Jo Becker et al., *White House Philosophy Stoked Mortgage Bonfire*, N.Y. TIMES, Dec. 20, 2008, at A1.

67. "Homeownership is one of the primary ways that households can build wealth." Souphala Chomsisengphet & Anthony Pennington-Cross, *The Evolution of the Subprime Mortgage Market*, FED. RES. BANK ST. LOUIS REV. 31 (Jan./Feb. 2006).

68. 12 U.S.C. §§ 2901-08.

69. See Paul S. Calem et al., *The Neighborhood Distribution of Subprime Lending*, 29(4) J. REAL EST. FIN. & ECON. 393, 407 (2004).

70. See Dennis R. Capozza & Thomas A. Thomson, 33 J. REAL EST. FIN. ECON. 241, 244 (2006), available at http://faculty.business.utsa.edu/tthomson/papers/CapozzaThomsonDefTransitions_20July2005.pdf.

71. The rate of "serious delinquency," defined as in foreclosure status or ninety or more days delinquent, was 1.12 percent for prime mortgages and 7.36 percent for subprime in 2003. Edward M. Gramlich, Governor, Fed. Reserve Bd., *Subprime Mortgage Lending: Benefits, Costs, and Challenges*, Remarks Before the Financial Services Roundtable Annual Housing Policy Meeting (May 21, 2004), available at <http://www.federalreserve.gov/Boarddocs/Speeches/2004/20040521/default.htm#>.

the amount of his or her down payment. As the subprime wave grew, the grade standards were lowered to allow more people into the mortgage market.⁷² The number of subprime loans grew dramatically from 1995 through 2006, as did the securitization of mortgages, especially of subprime loans.⁷³

Before 1980, it was not possible to charge high rates on mortgages. That changed, however, with the passage of the Depository Institutions Deregulation and Monetary Control Act (“DIDMCA”), which allowed higher interest rates.⁷⁴ The Alternative Mortgage Transaction Parity Act, enacted in 1982, allowed lenders to offer adjustable rate mortgages and to use balloon payments.⁷⁵ The lasting effect of these laws was to set the groundwork for subprime mortgages.

The freeing up of mortgage lenders, the encouragement for lenders to make more risky loans, and the development of the MBS market were the key factors leading to the creation of the huge subprime mortgage market, which collapsed in 2006.⁷⁶ Loans were made to people with poor credit and who were required to invest less and less on a down payment. Add to the mix the lenders’ increasingly easy access to funds to be lent from eager securitizers of mortgage loans, and the recipe for disaster is complete. Ultimately, lenders were simply giving large amounts of money to anyone who applied for a loan. Credit was not checked. Income was not checked. Appraisals were either falsified or ignored.

B. Personal Responsibility of the Home Owners

Many have argued that a free market lending system works well, forcing those who make mistakes to suffer the consequences. The Federal Reserve Board took a hands-off stance with respect to regulating lenders and their loan standards.⁷⁷ Encouraging homeownership among

72. Chomsisengphet and Pennington-Cross *supra* note 67, at 35.

73. *Id.* at 37.

74. 12 U.S.C. § 226 (1980).

75. *Id.* §§ 3801 (1982) et. seq.

76. Eric Lipton & Stephen Labaton, *A Deregulator Looks Back, Unswayed*, N.Y. TIMES, Nov. 17, 2008, at A1.

77. “I made a mistake in presuming that the self-interest of organizations, specifically banks and others, were such is that they were best capable of protecting their own shareholders and their equity in the firms,” Greenspan acknowledged in his recent Congressional testimony. “[I]t’s been my experience, having worked both as a regulator for 18 years and similar quantities, in the private sector, especially, 10 years at

those who had previously been precluded from the mortgage market was considered good social policy.⁷⁸ While a free market system is believed to punish those who make bad decisions, this theory presupposes that responsibility follows bad decisions. The disconnect between decision-making and responsibility which arose in the subprime lending market resulted in some people making a lot of money without bearing any responsibility.

The social and moral question centers around who should determine that a particular borrower cannot afford to pay the proposed mortgage. If the lender would suffer from a default, the lender should be inclined to refuse to make a mortgage loan. But since the lender could sell the bad loan to eager investors, the lender suffers no consequences from bad loans. The federal government did not caution borrowers in any way, nor did it provide roadblocks from unscrupulous lenders. Borrowers must be adequately informed with respect to any new mortgage, and they must be either counseled about bad decisions or simply prohibited from making them.

Some borrowers just did not understand the costs of their mortgage. Lured into adjustable mortgages with attractive “teaser” interest rates, these borrowers found that they made a mistake in borrowing these funds. Partly to blame is a lack of popular understanding or education about borrowing. Another culprit may be their lawyer’s inability or unwillingness to explain the possibility and consequences of later default. Although many lawyers do not believe that they have a duty to counsel their home buyer clients with respect to their ability to afford the proposed mortgage, it would seem that lawyers need to take a more proactive position. Either the lawyer or a paralegal should review the

a major international bank, that the loan officers of those [private] institutions knew far more about the risks involved and the people to whom they lent money, than I saw even our best regulators at the Fed capable of doing.” *Hearing, supra* note 31, at 33-34 (statement of Alan Greenspan, Chairman, Bd. of Governors, Fed. Reserve Sys., 1987-2006), available at <http://oversight.house.gov/documents/20081024163819.pdf>.

78. “[T]he plight of people who do not have adequate rental housing ought to be addressed,” wrote House Financial Services Committee Chairman, Rep. Barney Frank (D-Mass.), explaining the social policy reasons to support federal support for homeownership. Barney Frank, Letter to the Editor, *I’ve Long Been a Champion of Fannie/Freddie Reform*, WALL ST. J., Sept. 17, 2008, at A26; see also James R. Hagerty, *Fannie, Freddie Share Spotlight in Mortgage Mess*, WALL ST. J., Oct. 16, 2008, at A6. Others saw this as a politically expedient justification for the existence and growth of government sponsored enterprises Fannie Mae and Freddie Mac. Paul Giot, *The Fannie Mae Gang*, WALL ST. J., July 23, 2008, at A17.

financial information of the buyer and give a written analysis of the risk that the buyer cannot pay the mortgage. It should become an ethical duty for a lawyer to properly counsel their clients about the terms of their mortgage. For an attorney to sit by idly and watch a client pay excessive fees or other charges is simply not acceptable. Borrowers who are forced into foreclosure and suffer losses will seek defendants for lawsuits. Lawyers, who maintain malpractice insurance, are therefore likely targets. Both for the sake of their clients and to protect themselves from later lawsuits, lawyers should give their at-risk clients some financial counseling.

Any decision to incur debt depends upon the information available and the risk analysis made by the borrower. These credit decisions can be divided into three categories.⁷⁹

1. Rational Decisions

A rational decision is made under circumstances where the debtor has all necessary information. Most rational credit decisions generate good results, subject to market conditions. The most important factor in a rational decision making process is the borrower's ability to pay back the loan. Due consideration should be given to the advice of qualified and disinterested (not compensated based on the outcome of the decision) financial advisors. Such advice must become part of the mortgage process.

2. Irrational Decisions

Some debtors make irrational decisions based on an incorrect risk analysis or simply due to poor decision-making, even if they have access to all relevant information. More likely, these debtors lack sufficient financial knowledge, capabilities and competent financial advice. Our society does not seem to value financial ability and has allowed too many people to make bad decisions. The availability of credit has lured millions into debt which they cannot pay. Although the credit industry has thrived on luring people into making bad financial decisions, some protection is needed in the mortgage market. Those who make irrational decisions on their face must be warned of the consequences. While it is

79. See Vincent Rougeau, *Rediscovering Usury: An Argument for Legal Controls on Credit Card Interest Rates*, 67 U. COLO. L. REV. 1 (1996).

not practicable to intervene in every credit card purchase, it is possible to intervene in bad mortgage decisions. If the loan is a high interest loan or is clearly outside of the person's ability to repay the loan, such intervention should be required.

3. *Irresponsible Decisions*

Some debtors will make a credit decision based upon insufficient information, or they may be indifferent to the information available. When markets are rising rapidly, a certain number of borrowers will make "greed"-based decisions. These are the speculators who do not process available information in a rational manner.⁸⁰ When speculators see people making money in real estate, the assumption of excessive risk becomes acceptable to them because of their nature. The role of speculation in the real estate market has always been significant. At what point should the government deter speculators? It would seem that some controls are necessary when speculators threaten the viability of rational markets and the financial well-being of others. Speculation has always been a part of the economic system, softened by the availability of bankruptcy. However, when speculation threatens the viability of entire neighborhoods, it is probably better to reign it in before the damage is done. Lenders must be especially careful when extending credit to speculators and should be required to "tag" these loans accordingly. Prospective investors in mortgage backed securities should be alerted to the increased risk associated with securities which include loans to speculators.

There is also the possibility that available information is incomprehensible. The extension of credit and the regulation of credit products should be designed to protect borrowers and lenders from these categories of credit decision makers. Those making rational decisions need as much information as possible. Some people need financial advice before making a major decision. Others simply will not be deterred by any advice or warnings, although they should be.

80. See, e.g., Lloyd T. Wilson, Jr., *Effecting Responsibility in the Mortgage Broker-Borrower Relationship: A Role for Agency Principles in Predatory Lending Regulation*, 73 U. CIN. L. REV. 1471, 1473 (2005) (describing "information asymmetry," which analyzes the situation where the lender has more information than the borrower).

D. Lenders

Probably the biggest disconnect in our mortgage system, which led to the subprime debacle, was the explosion of lenders who entered the housing market.⁸¹ Historically, home mortgages were given almost exclusively by savings and loan associations and banks. Mortgage brokers were people who helped individual buyers find the best deal on a mortgage. These things changed dramatically during the bubble. Mortgage banks, many employing brokers of their own, started providing the mortgages to borrowers, then selling the mortgages thereafter in bulk to banks.⁸² Numerous mortgage companies sprang up. Countrywide Mortgage, a dedicated mortgage company, became the largest nationwide lender,⁸³ displacing the traditional banks. The profits to be made on more expensive mortgages led to a rapid, unregulated expansion of the types of lenders and loans available to a borrower.

81. Subprime lender New Century told its shareholders the firm faced “intense competition” from other mortgage banking companies, consumer finance companies, commercial banks, credit unions, thrift institutions, credit card issuers, insurance finance companies, Internet-based lending companies and other large financial institutions. “The intense competition in the mortgage industry has led to rapid technological developments, evolving industry standards and frequent releases of new products and enhancements.” New Century Financial Corp., Annual Report, *supra* note 56. The boom was also fueled by traditionally conservative lenders, which jumped into the fray by delving into riskier products: J.P. Morgan Chase & Co. began allowing some of its customers to take out home-equity loans and lines of credit without having their incomes verified; Wells Fargo & Co. began allowing buyers of investment properties in some parts of the country to take out interest-only mortgages; and Washington Mutual Inc. began offering home-equity lines of credit to borrowers who buy condominium units as an investment or as a second home and let borrowers who buy a second home or investment property finance as much as 90% of the home’s value, up from 75%. See Simon, *supra* note 6.

82. See The Subprime Crisis: An Overview, *supra* note 44, at 18-20. Sometimes these mortgage backed securities were then repackaged again, split up into tranches and securitized again as collateralized debt obligations (CDOs), with global CDO issuance exploding from \$85 billion in 2002 to \$549 billion in 2006. *Id.* at 20. Securitization was especially prevalent among subprime mortgage lenders. New Century, for example, funded its operations loan sales and securitizations structured as sales. Interestingly, the firm began reversing course in 2003, retaining a portion of its loan production on its balance sheet “for investment,” extracting liquidity from its holdings by structuring securitization as financings rather than sales. New Century Financial Corp., Annual Report, *supra* note 56.

83. Gretchen Morgenson, *Inside the Countrywide Lending Spree*, N.Y. TIMES, Aug. 26, 2007, § 3, at 1.

The brokers connecting borrowers with these new lenders created a new form of a “boiler room,” not focusing on stocks, but rather selling a new menu of mortgages.⁸⁴ Quick fortunes were made because poorly qualified borrowers were willing to pay excessive interest rates and transaction fees. Mortgage brokers earned excessive commissions by bringing these unqualified borrowers to mortgage banks. The higher the transaction costs and interest the borrowers were willing to pay, the higher the commission the broker stood to earn.⁸⁵

This would not have been possible without the concurrent explosion of the MBS market, which allowed lenders to package their loans and sell them to investors, thereby creating more cash to make more loans. Since the mortgages were sold, the lender did not retain any liability for nonpayment of the mortgages.⁸⁶ There was a disconnect between the people making the lending decision, and the people ultimately bearing the risk of default. This disconnect allowed lenders to make loans seemingly without any consideration of the consequences.⁸⁷ No income verification, no appraisal, no credit check, so what?⁸⁸ Conservative lending institutions which did not lower their lending standards did not see excessive defaults in their mortgages.⁸⁹ A clear lesson from the mortgage debacle is that lenders must adhere to proven standards in making loans. If those standards are not met and the loan is made anyway, then such a poor loan needs to be designated clearly when sold as an MBS. These loans should not be packaged and securitized together with stronger loans.

E. Securitization of Mortgage Backed Securities

Mortgage debt has been sold to investors since 1938 when Fannie Mae was created.⁹⁰ The government sought to enhance liquidity in the

84. Gretchen Morgenson, *Was There a Loan It Didn't Like*, N.Y. TIMES, Nov. 2, 2008, § BU, at 1. “At WaMu it wasn’t about the quality of the loans: it was about the numbers.” *Id.*

85. *Id.*

86. See Georgette Chapman Poindexter, *Dequity: The Blurring of Debt and Equity in Securitized Real Estate Financing*, 2 BERKELEY BUS. L. J. 233 (2005).

87. See, e.g., Simon, *supra* note 6.

88. See *id.*

89. See, e.g., Peter Beller, *Hudson City Bancorp: Bland is Beautiful*, FORBES, Dec. 20, 2007, available at http://www.forbes.com/2007/12/20/best-managed-banking-biz-cz_pb_08platinum_1220hudson.html.

90. National Housing Act, 48 Stat. 1246 (1938), 12 U.S.C. § 1716, tit. III, et seq.

market for home loans by providing a vehicle in which mortgages could be packaged by lenders into mortgage backed securities, freeing up funds for new mortgage lending and expanding the pool of credit available to prospective homebuyers. This process has fostered home ownership. The central reason it worked, however, was the establishment of well-defined lending standards by the government-sponsored enterprises, such as Fannie Mae.⁹¹ Because the GSEs bought conforming mortgages, banks interested in tapping the GSE-supported liquid market for conforming mortgage backed securities had to adhere to the GSE's rigorous underwriting criteria. Historically, loan defaults were very rare and buying these securities as an investment was a very conservative investment decision.⁹² Investors came to know that purchasing packaged mortgages brought a nice, secure return on investment.

Beginning in the late 1970s, creative investment bankers began to develop more complex, sophisticated securities backed by mortgages.⁹³

91. See *supra* note 16.

92. See *Bd. of Trade v. SEC*, 677 F.2d 1137, 1139 (7th Cir. 1982) (citing "favorable yields, good liquidity and a high degree of safety" as the reason for institutional investor interest in mortgage backed securities), *vacating as moot* 459 U.S. 1026 (1982); see also *Olkey v. Hyperion 1999 Term Trust, Inc.*, 98 F.3d 2, 5 (2d Cir. 1996) (finding "[a] reasonable investor could not have read the prospectuses without realizing that, despite the use of balancing in an attempt to minimize the impact of fluctuating interest rates, a significant downturn in interest rates could decrease the value" of the mortgage backed securities in a trust with both interest-only strips (IOs) of mortgages, which tend to go up with interest rates, and mortgage-backed securities, which tend to go down when interest rates go up); *Hurst v. Crosby*, 2006 U.S. Dist. LEXIS 24755, at *3-4 (N.D. Fla. Feb. 9, 2006) (citing "the possibility of high return" despite "high risk" as the reason for investor interest). *Contra Banca Cremi, S.A. v. Alex. Brown & Sons, Inc.*, 132 F.3d 1017, 1022 (4th Cir. Md. 1997) (noting "historically, investments in fixed-rate home mortgages have not been attractive to institutional investors," because "mortgages perform poorly both when interest rates rise and when they fall").

93. The first private asset-backed security was issued by Bank of America in 1977. It consisted of a simple pass-through structure, with only one tranche. Once investors became comfortable with MBS and predicting mortgage performance, the securities became substantially more complex. Mason & Rosner, *supra* note 2, at 20. Exotic hedges and a global marketplace emerged almost immediately thereafter. Then, as now, a shadow market with undisclosed obligations and uncertain rules sowed litigation and confusion in times of economic distress. In one illustrative 1978 transaction, for example, a Texas credit union purchased a hedge against the possibility of falling interest rates on a Government National Mortgage Association bond from a Tennessee securities trading firm, which immediately entered into another hedge on the same instrument with an Argentinean bank. See *LTV Fed. Credit Union v. UMIC Gov't Sec.*,

For a world searching for the greatest return on investment, without understanding the risks involved, these new MBS became the hottest rage. The MBS market became the most active market in the world, surpassing even the New York Stock Exchange.⁹⁴ The market for MBS in the

Inc., 523 F. Supp. 819 (N.D. Tex. 1981), *aff'd* 704 F.2d 199 (5th Cir. 1983). By the early 1980s, a robust futures market for mortgage securities emerged. Lenders employed these instruments in ways that made mortgage markets more efficient, such as hedging against the possibility of falling interest rates between the date an issuer makes a firm commitment to extend credit to a homebuilder and the date the securities are actually issued. See *Abrams v. Oppenheimer Gov't Sec., Inc.*, 737 F.2d 582, 584 (7th Cir. 1984) (noting "issuers generally sell GNMA forward contracts to broker-dealers . . . who in turn enter into contracts for forward delivery with investors Because GNMA's (GNMA 'actuals') and GNMA forward contracts are fully transferable from one investor to another, markets for these instruments have evolved, and their value may vary."). In the 1990's a market for derivative instruments emerged. See *In re TCW/DW North Am. Gov't Income Trust Secs. Litig.*, 1997 U.S. Dist. LEXIS 18485, at *9 (S.D.N.Y. Nov. 20, 1997) (noting "[m]ortgage-backed securities have become increasingly complicated financial products, and now include among their number several mortgage derivative securities."). By the beginning of the present decade, borrowers learned how to leverage the liquidity afforded by this market to their advantage. The Subprime Crisis: An Overview, *supra* note 44, at 13. In 2005, the majority of subprime ABS was bought by another securitization vehicle that issued further bonds. *Id.* at 20.

94. Trading of residential mortgages and related debt overshadowed trading in the stock market in 1985, after quadrupling to \$2 trillion between 1981 and 1986. During this period MBS instruments became more complex, as mortgage-backed agency debt's share of the market declined from 42.5% in 1981 to 28.5% in 1986, while volume in pass-through mortgage securities rose from 48.6% to 61.4% during the same period. Robert Guenther, *Mortgage-Exchange Proposal Is Studied: Heavy Trading Volume Strains Current System*, WALL ST. J., Feb. 26, 1986. Increased volume has not necessarily enhanced liquidity, however, especially for subprime mortgage debt. In 2005, a London firm launched an index, the ABX, which tracks a basket of 20 subprime MBS with an original value of \$28 billion. Traders rely on the relatively small \$3 to \$4 billion in trading volume on the ABX to price subprime securities in an overall market valued at approximately \$1 trillion. By comparison, there is a \$179 billion average daily trading volume in S&P 500 index futures and options contracts on the Chicago Mercantile Exchange. Serena Ng, et al., *A 'Subprime' Gauge, in Many Ways? - ABX, Warts and All, Is 'Only Game in Town'*, WALL ST. J., Dec. 12, 2007, at C1. Some of the strain falls on the even more opaque market for "credit-default swaps." The "notional" values of outstanding CDS soared from \$34.5 trillion at the end of 2006 to \$45.5 trillion in 2007, a 37% jump. A CDS represents a promise by one firm to make regular payments to another firm, if a specified bond or loan defaults. Investors use these swaps for both hedging and speculating. Serena Ng, *Default Swaps: One Boom in the Crunch - Volume Soared in '07 as Woes Worsened*, WALL ST. J., Apr. 16, 2008, at C2.

United States grew from \$639 Billion in 1995 to \$3.3 Trillion in 2005.⁹⁵ In order to feed the growing appetite for these investments, eager investment bankers created newer and more complex investment instruments.⁹⁶ Mortgages extended to creditworthy borrowers were pooled alongside mortgages with more uncertain payment prospects and packaged as mortgage backed securities. These packages included prime, subprime and Alt-A mortgages in groups of 1000 to 25,000 mortgages.⁹⁷ Some high quality, low risk mortgages were packaged with higher risk mortgages, promising a higher rate of return. As demand for mortgages and MBSs increased, the banks responded by packaging increasingly risky mortgages and selling them to unwary investors.

When a bank makes a loan, it may hold that loan on its books or sell the loan to a trust or other Special Purpose Entity (“SPE”, sometimes also called Special Purpose Vehicle or “SPV”).⁹⁸ These loans are bundled together and turned into a security, which is owned by the SPE and then sold to investors.⁹⁹ Through this securitization, the investors have the beneficial interest in the loans while the bank retains some

95. *Hearing, supra* note 31 (statement of Frank L. Raiter, Managing Director and Head of Residential Mortgage Backed Securities Ratings Group, Standard and Poor’s, Mar. 1995-Apr. 2005), available at <http://oversight.house.gov/documents/20081022102804.pdf>.

96. See generally Andrew Kelman, *Mortgage-backed Securities & Collateralized Mortgage Obligations: Prudent CRA INVESTMENT Opportunities*, CMTY. INVS. (Fed. Reserve Bank of San Francisco, San Francisco, C.A.), Mar. 2002, at 20, 22-23, available at <http://www.frbsf.org/publications/community/investments/cra02-2/mbs.pdf> (touting “the innovative and complex CMO structure [which] enables banks to leverage investment in affordable housing from non-CRA regulated institutions, since the long cash flows are sold to pension funds and insurance companies”).

97. *Hearing, supra* note 31 (statement of Frank L. Raiter, Managing Director and Head of Residential Mortgage Backed Securities Ratings Group, Standard and Poor’s, Mar. 1995-Apr. 2005), available at <http://oversight.house.gov/documents/20081022102804.pdf>.

98. See Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 135 (1994). Originators find it desirable to transfer loans to a newly formed special purpose corporation, trust, or other legally separate entity (often referred to as a special purpose vehicle, or “SPV”) to separate the receivables from risks associated with the originator. *Id.*

99. In order to attract investors and reassure credit risk insurers, an originator must or forego its right to the residual value of the receivables sold to a SPE. *Id.* at 141. Tax and accounting rules require the originator inject a minimum level of capital into the SPE, typically 1% to 3% of the amount securities issued, to legally shift the liabilities associated with the loans from the originator to the SPE. *Id.* at 138. Investors then assume the risks associated with servicing and collecting the receivables. *Id.* at 151.

residual interest, or possibly some of the beneficial interest.¹⁰⁰ The structure of a loan securitization involves a trust agreement between the bank and the SPE specifically defining the duties and obligations of the SPE.¹⁰¹ The parties also execute a transfer and servicing agreement between the bank and the SPE, whereby the bank agrees to collect and distribute the payments on the mortgages after the sale of the mortgages to the SPE.¹⁰² Other entities and agreements are used to ensure that each investor is paid the correct amount based on the incoming payment stream on the underlying mortgages. This securitization process provides an inexpensive and efficient method to finance new loans.¹⁰³ In theory, it also takes loans off the balance sheet of the originating bank and shields them from defaults.

F. Investors

One of the credos of investing in securities is that you should not invest in anything you do not understand. Many investors, even sophisticated investors and professional money managers, did not understand the complex MBSs created by the investment bankers and did not understand the risks involved with purchasing these investments. The CRAs provided little help because their ratings did not adequately convey the

100. *Id.* at 141.

101. “The single-purpose entity is a hallmark of securitized lending, and conduit loan documents usually contain detailed requirements for the borrower’s structure,” specifying which entity or entities must be SPEs and what provisions must be contained in their organizational documents. Lenders typically require the provisions of the SPE match the conduit loan documents verbatim. Lisa Connolly, et al., *Debt Transfer: Loan Assumptions Provide a Funding Source During Challenging Economic Times*, COM. INV. REAL EST. MAG., Nov.–Dec. 2008, available at http://www.ciremagazine.com/article.php?article_id=1297.

102. Pools of securitized loans are serviced pursuant to pooling and servicing agreements, with day-to-day loan issues managed by one or more servicers. The common division of loan servicing responsibilities is often between a master servicer and a special servicer. Master servicers generally service loans that are not in default, while special servicers handle loans in default. *Id.*

103. See ADAM B. ASHCRAFT & TIL SCHUERMANN, FED. RESERVE BANK OF NEW YORK, STAFF REPORT: UNDERSTANDING THE SECURITIZATION OF SUBPRIME MORTGAGE CREDIT 39 (Mar. 2008). Securitization enables originators to obtain low cost, off balance sheet, capital market funding. Schwarcz suggests the use of securitization by investment grade companies is evidence of the value of securitization, noting “profit maximizing companies generally do not engage in activities whose benefits are illusory.” Schwarcz, *supra* note 98, at 146.

risk involved with these investments.¹⁰⁴ Investors simply did not grasp the poor quality of the mortgages which were being made.

Agencies charged with rating these securities made significant errors in their rating schemes.¹⁰⁵ CRAs are paid by the issuers, who have a significant incentive to increase the rating.¹⁰⁶ The CRAs saw little duty to the investors who were relying on the ratings. In any case, the CRAs made mistakes. Either the bankers lied or misled them, or the CRAs simply did a poor job in their due diligence.¹⁰⁷ Many of these

104. Institutional investors rely on CRAs to maintain the credit quality of their investments. A bond fund's investments typically range in quality from securities rated in the lowest category in which the fund is permitted to invest to securities rated in the highest category "as rated by Moody's, S&P or Fitch, or, if unrated, determined . . . to be of comparable quality." PIMCO TOTAL RETURN FUND PROSPECTUS (share class P) app. at A1 (Sept. 1, 2008). The PIMCO Total Return Fund, for example, invests for "maximum total return consistent with preservation of capital and prudent investment management" by investing in bonds with credit ratings from B to Aaa, and is restricted to a maximum of 10% of total assets below Baa. *Id.* at 5. The Reserve Primary Fund seeks to maintain suitability for investors who desire "greater security and liquidity than other types of investments" without "as high a rate of return," by investing in "securities rated in one of the two highest short-term ratings, generally by two of the nationally recognized" CRAs. RESERVE LIQUID PERFORMANCE MONEY MARKET FUND PROSPECTUS 3-4 (Mar. 28, 2008) [hereinafter RESERVE PROSPECTUS].

105. "[T]he data inputted into the risk management models generally covered only the past two decades, a period of euphoria," Greenspan told Congress. *Hearing, supra* note 31, at 18-19 (statement of Alan Greenspan, Chairman, Bd. of Governors, Fed. Reserve Sys., 1987-2006), available at <http://oversight.house.gov/documents/20081024163819.pdf>. While CRAs awarded the "gold standard" AAA rating to an elite group of approximately 12 blue-chip corporations as of the fall of 2007, more than half of the mortgage bond debt outstanding (by value) were rated AAA. Some of these bonds were "backed by risky subprime loans." To facilitate this rating investment banks "deliberately fashion some bonds to pay higher yields – but also to absorb any losses first," from a large pool of loans, divided according to credit risk and interest rate yield, so up to 30% of the loans in a pool would need to go bad before a AAA-rated bond would take a loss. Unfortunately, these projections did not pan out and in August 2007 Standard & Poor's lowered the rating on two hard-hit structured vehicles from AAA to CC. Aaron Lucchetti & Serena Ng, *Triple-A Ratings Grade on a Curve, Making It Difficult to Assess Risk*, WALL ST. J., Oct. 6, 2007, at B1.

106. See Lucchetti, *supra* note 9.

107. *Id.* Originators claiming the ability to reasonably predict the aggregate rate of default have been able to securitize receivables with a substantial risk of uncollectibility for over a decade, a phenomenon Schwarcz discussed in his 1994 article, but the ability to accurately assess the risk of nonpayment is an important factor in valuing such receivables. See Schwarcz, *supra* note 98, at 135. Investors rely on CRAs to perform this evaluative function.

rated securities were given bond ratings which far exceeded their actual value.¹⁰⁸ State investment funds, pension funds, hedge funds, investment banks – all of these supposedly sophisticated investors – were purchasing investments which carried far more risk than was believed.¹⁰⁹

Incredibly, not only did the investment banks purchase and sell these risky investments, but they also lent money to other investors to purchase the securities. Citigroup lent much of the purchase price to some hedge funds investing in MBS.¹¹⁰ Anxious to sell their MBS offerings to investors, banks were all too happy to finance the purchase price. This combination of involvement almost caused some of our biggest investment banks (e.g., Citigroup, Merrill Lynch) to fail. Unfortunately, some of our best-known investment banks, Bear Stearns and Lehman Brothers, did fail because of the subprime crisis.

108. See Bertschi, *supra* note 8; RESERVE PROSPECTUS, *supra* note 104, at 3. The Reserve Fund was restricted to investments of only the highest credit quality, bonds qualifying for the two highest short-term credit ratings, yet was still able to maintain to \$785 million in exposure to now-bankrupt investment bank Lehman Brothers when the firm defaulted on its loans. Peter Rizzo & Francoise Nichols, *Credit FAQ: How Are Events In The Financial Markets Affecting Money-Market Funds?*, RatingsDirect (Standard & Poor's, New York, N.Y.), Sept. 30, 2008, at 2, available at <http://www2.standardandpoors.com/portal/site/sp/en/us/page.article/2,1,6,5,1204839960577.html>. In the ensuing two days, investors to withdraw 60% of The Reserve's \$40 billion asset base. *Id.* The Reserve became the first money fund open to the general public to "break the buck", even though the fund successfully held a share price of \$1 since its inception and managers intended to keep it that way as of March 2008. See John Waggoner, *Reserve Primary Money Market Fund Breaks a Buck*, USA Today, Sept. 17, 2008; Reserve Prospectus, *supra* note 104. S&P defended its performance:

[W]e first discuss actions that the management team is considering given the current circumstances to understand how the action may affect our view of the fund's NAV and our assessment of the rating level. We generally will not take an immediate rating action if management intends to take supportive actions to preserve the fund's NAV in a timely manner, and presents us with a credible plan to do so.

Rizzo & Nichols, *supra* note 108, at 5.

109. See Lucchetti, *supra* note 9.

110. See generally Bradley Keoun, *Citigroup's \$1.1 Trillion of Mysterious Assets Shadows Earnings*, BLOOMBERG, July 13, 2008, <http://www.bloomberg.com/apps/news?pid=20601109&refer=home&sid=a1liVM3tG3aI>. Citi set up off balance sheet structured investment vehicles and used leverage to buy up \$100 billion worth of subprime collateralized debt obligations. Andy Kessler, *What's Next for the Banks?*, WALL ST. J., Jan 24, 2008, at A17.

G. Global Investment

Outside of the United States, the international community has been profitably selling the U.S. goods and looking for someplace to invest these profits.¹¹¹ Since the U.S. markets have always been viewed as the most secure, much of the foreign investment money has been reinvested in the American securities markets.¹¹² The investment bankers took advantage of this inflow of capital to sell these foreign investors what they were seeking: high yielding, secure investments. This has been described as a “global savings glut.”¹¹³ This inflow of foreign investment created a greater demand for investment vehicles, including MBS. Everyone wanted to profit from the flourishing U.S. housing market and its rapidly expanding lenders.

Foreign investors, foreign pension funds, foreign municipal funds, and other types of foreign investors were lured into relatively high yielding MBSs which were highly rated by respected CRAs. In normal times, these investment decisions would be quite rational. These, however, were not normal times.

H. Appraisers

The appraisers who inspect the property to be given a mortgage are another key ingredient in the origination process.¹¹⁴ Their job is to

111. See Stephen Roach, *Imbalances Matter More than Ever*, GLOBAL ECON. FORUM (Morgan Stanley, New York, N.Y.), May 5, 2006, <http://www.morganstanley.com/views/gef/archive/2006/20060505-Fri.html>, accord Kenneth Rogoff, *Betting With the House's Money* (Brookings, Washington, D.C.), Feb. 15, 2007, http://www.brookings.edu/opinions/2007/0215monetarypolicy_rogoff.aspx?p=1.

112. See Paul Blustein, *Foreign Investment's Flip Side; U.S. Trade Deficit Swells Along With Consumption, Debt*, WASH. POST, Feb. 25, 2005, at A01.

113. See Ben S. Bernanke, Governor, Fed. Reserve Bd., Remarks at the Sandridge Lecture, Virginia Association of Economics, Richmond, Virginia (Mar. 10, 2005), available at http://www.networkideas.org/feathm/sep2006/pdf/bernanke_2005.pdf.

114. Historically, the appraisal was a six-step process that included: (1) definition of the problem; (2) preliminary survey and appraisal plan; (3) data collection and analysis; (4) application of the three approaches to value, (5) reconciliation of value indications; and (6) final estimate of defined value. In an effort to increase efficiency and reduce costs, the lending industry has significantly increased reliance on automated value models. Mason & Rosner, *supra* note 2, at 9 (citing Debra Cope, ACB 13th Annual Real Estate Lending Report (2006)). Appraisers with access to databases of recent sales sometimes employ OLS regression. If there is insufficient data, the grid adjustment method is used. Michael Lacour-Little & Richard K. Green, *Are Minorities*

ensure the underlying property has sufficient value to support a mortgage. In the event of a default, the lender will recover the principal amount of the mortgage. The industry standard has been that the maximum amount of a mortgage given on a specific property should not exceed 80% of the appraised value.¹¹⁵ If a mortgage lender wishes to make a loan, he does not want to be told that the property does not have sufficient value. If the appraiser asserts a lower value, the lender may simply find a more aggressive appraiser. Since many lenders were getting significant fees simply for making the loan and were not exposed to default risk, it became more desirable to make the loan, earn the fee and move on to the next loan. Appraisers were under significant pressure to come up with inflated appraisals.¹¹⁶ In a recent survey of appraisers, 91% replied that they had been asked to inflate an appraisal value of a home.¹¹⁷ The end result was a decrease in the cushion when a mortgage began to fail. Even in a foreclosure, the owner of the mortgage would lose money because a forced sale could not generate enough to pay the mortgage balance. As the price of homes decreased, this problem was greatly exacerbated. Millions of homes now have mortgages which far exceed their value.¹¹⁸ The result is that not only the

or Minority Neighborhoods More Likely to Get Low Appraisals?, 16 J. OF REAL EST. FIN. & ECON., 301, 304 (1998).

115. The Subprime Crisis: An Overview, *supra* note 44, at 13. Also, appraisers were traditionally chosen from organized blind pools and randomly assigned. This practice has been largely abandoned. Mason & Rosner, *supra* note 2, at 9.

116. A mortgage broker's compensation increases with the value of the loan, giving these brokers a strong incentive to increase the appraised value of the home. The appraisal industry has repeatedly and routinely complained of pressures to "hit the bid." Those who are unwilling to succumb to these pressures face the risk of lost business. Mason & Rosner, *supra* note 2, at 9. The New York Attorney General, Andrew Cuomo, filed a lawsuit against First American Corp., a real estate appraisal firm, on Nov. 1, 2008. The suit alleges that Washington Mutual, a bank, had pressured First American to hire appraisers who would inflate property values.

117. *Survey Shows Appraisers Experience Pressure from Requestors*, REUTERS, May 14, 2008, <http://www.reuters.com/article/pressRelease/idUS141380+14-May-2008+BW20080514> (describing a survey of appraisers).

118. The balance on millions of home mortgages exceeds the current value of the collateral. Estimates vary widely on the extent of the problem. See Edmund L. Andrews & Louis Uchitelle, *Rescues for Homeowners in Debt Weighed*, N.Y. TIMES, Feb. 22, 2008, at A1 (8.8 million homeowners or 10.3 % of the total); Karen Blumenthal, *Family Money: 'Underwater' Need Not Mean Foreclosure*, WALL ST. J., Nov. 5, 2008, at D1 (between one in six and one in eight homeowners); Editorial, *The Next \$300 Billion*, WALL ST. J., Oct. 9, 2008, at A16 (12 million mortgages); David

home owner, but also the lender, will suffer substantial loss in a foreclosure.¹¹⁹

I. Credit Rating Agencies

The CRAs were issuing ratings which were not supported by the underlying instruments.¹²⁰ Mortgages were bundled into groups and given triple A ratings.¹²¹ CRAs were making outsized profits from rating MBS, which were paid by their clients – the issuers of the MBS.¹²² They behaved not as protectors of investors, but as enablers of the banks who were issuing the securities.¹²³

Streitfeld, *Mortgage Plan May Aid Many And Irk Others*, N.Y. TIMES, Oct. 31, 2008, at A1 (10 million homeowners); see also Demyanyk & Van Hemert, *supra* note 37. Bankers would be hard pressed to argue this was an unexpected phenomenon. A study, published in 1974, of delinquency rates for mortgages originated between 1961 and 1972 on single-family homes located within the Pittsburgh area found a strong correlation between delinquencies and borrower equity. When the LTV ratio increases from 80% to 90%, delinquency rates should increase by over two-thirds. If the LTV ratio rises an additional 5%, from 90% to 95%, delinquency rates would jump by another 70%. The study concluded “[a] rising equity-value ratio has the expected effect of lowering delinquency risk.” George M. von Furstenberg & R. Jeffery Green, *Home Mortgage Delinquencies: A Cohort Analysis*, 29 J. OF FIN. 1545, 1547 (1974).

119. Government-sponsored enterprises (GSEs) recognize the “near certainty of losses on most foreclosures,” and require buyers with a LTV ratio in excess 80 percent to purchase private mortgage insurance to mitigate the risk of loss to the GSE and MBS investors. Lenders sustained enormous losses in real-estate-owned (REO) portfolios during the late 1980s, typically losing between 30 and 60 percent of the outstanding mortgage balance on a foreclosed home. Mason & Rosner, *supra* note 2, at 7-8, 12.

120. STAFF OF THE OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATION, DIV. OF TRADING & MKTS., OFFICE OF ECON. ANALYSIS, U.S. SEC. & EXCH. COMM’N, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF’S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES (July 2008), available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf> [hereinafter SEC SUMMARY REPORT].

121. *Id.*

122. *Hearing, supra* note 31 (statement of Frank L. Raiter, Managing Director and Head of Residential Mortgage Backed Securities Ratings Group, Standard and Poor’s, Mar. 1995-Apr. 2005), available at <http://oversight.house.gov/documents/20081022102804.pdf>.

123. Frank Partnoy, *Second-Order Benefits from Standards*, 47 B.C. L. REV. 169, 190 (2007); see *Hearing, supra* note 31 (statement of Frank L. Raiter, Managing Director and Head of Residential Mortgage Backed Securities Ratings Group, Standard and Poor’s, Mar. 1995-Apr. 2005), available at <http://oversight.house.gov/documents/20081022102804.pdf>.

Ratings were issued without proper analysis of the bundled mortgages.¹²⁴ In many cases, the CRAs did not even have access to the individual mortgages, yet they continued to issue prime ratings for the MBSs.

The credit rating issued by a CRA is an overall assessment of a debt obligor's creditworthiness and is meant to reflect only credit risk or default risk.¹²⁵ The instrument issued by an obligor, the MBS, is the item being analyzed and rated. When issuing a rating, the CRAs take into account the following loan underwriting characteristics¹²⁶:

(1) *Cumulative loan to value ratio:*

The higher loan to value ratio, the less likely the loan will perform. Since the borrower has less equity invested in the home there is less incentive to attempt to save a loan when the borrower has little equity to save. The standard for a conforming loan is that the amount of the loan be no more than 80% of the value of the property. When a package of loans has a high loan to value ratio, the risk is increased.

(2) *Consumer credit score:*

The higher the credit score, the more likely the loan will be paid. If the average credit score on a package of loans is low, then the risk of default is increased. Average credit scores below 720 indicate higher risk of default.

(3) *Loan maturity:*

Shorter term loans realize fewer defaults. Longer terms, especially ones exceeding 30 years, indicate a greater risk of default. The term of years is one of the least useful indicators of default.

(4) *Interest rate:*

If the interest rate charged on the mortgages exceeds the average for all loans, the risk of default is greater. A higher interest rate

124. *Id.*

125. ASHCRAFT & SCHUERMANN, *supra* note 103.

126. See *Hearing*, *supra* note 31, at 2-3 (statement of Frank L. Raiter, Managing Director and Head of Residential Mortgage Backed Securities Ratings Group, Standard and Poor's, Mar. 1995-Apr. 2005), available at <http://oversight.house.gov/documents/20081022102804.pdf>; *Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 110th Cong. (Sept. 26, 2007) (testimony of Michael Kanef, Group Managing Dir., Moody's Investors Serv.), available at http://banking.senate.gov/public/_files/kanef.pdf.

indicates a lender's assessment of the loan's greater risk. Many subprime loans carried excessive interest rates, reflecting both the lack of sophistication of the borrowers and the higher risk assessed by the lender. High average interest rates in a package of loans indicate a higher risk of default.

(5) *Fixed rate versus adjustable rate:*

The default rate on ARMs is higher than on fixed rate mortgages. This is a result of the teaser rates offered to ARMs borrowers, which reset to much higher rates after the initial term.

(6) *Property Type:*

The type of property (single family, condo, multi family) has an impact on the default rate. More condos and multi family properties tend to be investment properties, reducing the incentive to try to save a distressed mortgage.

(7) *Home Value:*

Properties having a lower value have a greater risk of default. Many entry level purchasers buy lower value homes, and many speculators concentrate on lower value homes.

Credit rating agencies are hired by and paid by issuers of securities. If the issuer does not get the result from the CRA that it wants, it can simply take the lucrative business of rating securities elsewhere. The rating agency relies entirely upon the fees paid by the issuer of a security. There is tremendous pressure to bring forth the expected rating. Thus, both the information given and the complexity of the securities are controlled by the issuers. A serious conflict of interest between the agencies and their employers exists. The CRAs find it in their own self-interest to issue as favorable a rating as possible. At the same time, investors who rely on the credit rating agencies are unable to analyze the accuracy of a credit rating. The investor is exposed to errors in the rating process, but has no input into the process.

Conversely, in a corporate bond, the issuer, not the instrument, is rated.¹²⁷ When rating a corporate bond, the CRAs are able to analyze the issuer's financial strength and capability to react to adverse occurrences. When rating an Asset Backed Security ("ABS"), however, the security's terms are fixed and cannot react to adverse occurrences. Despite this important difference, Standard and Poor's claims its

127. See Lucchetti & Ng, *supra* note 105.

“ratings represent a uniform measure of credit quality globally and across all types of debt instruments. In other words, an ‘AAA’ rated corporate bond should exhibit the same degree of credit quality as an ‘AAA’ rated securitized issue.”¹²⁸ An investor who relies on these ratings, and believes that the rating for an ABS is equivalent to the rating for a corporate bond, is being misled. Defaults by investment grade rated corporate bonds are very rare. Default rates for investment grade bonds (Aaa-Baa), for a long period (from 1983-2000), were calculated at .073%.¹²⁹ The default rate for risky “junk bonds” rose to 2.0% in April, 2008.¹³⁰ The default rate for subprime mortgages is in excess of 10% and is still rising.¹³¹

Many of these subprime mortgages were packaged and sold as ABSs. Clearly, these should not have been rated Aaa. The default rate on these mortgages is far higher than an investor should expect for highly rated investments.¹³²

128. Calvin R. Wong & Thomas G. Gillis, *Principles-Based Rating Methodology for Global Structured Finance Securities*, RATINGSDIRECT (Standard & Poor’s, New York, N.Y.), May 29, 2007, at 4, available at <http://www2.standardandpoors.com/spf/pdf/fixedincome/PrinciplesBasedRatingMethodology.pdf>.

129. MOODY’S INVESTORS SERV., INC., GLOBAL CREDIT RESEARCH, SPECIAL COMMENT: CORPORATE DEFAULT AND RECOVERY RATES: 1920-2006 23-24 (Feb. 2007), available at http://www.moody.com/cust/content/Content.ashx?source=StaticContent/Free%20Pages/Regulatory%20Affairs/Documents/default_and_recovery_rates_02_07.pdf.

130. Default rate for issuers of U.S. corporate junk bonds rated BB+ and below by Standard & Poor’s are expected to “catapult” to an all-time high of 13.9% by December 2009, according to a January 22 Standard & Poor’s report. David Hoffman, *Managers Tread Carefully In Making Picks; High-Grade Corporates, Munis Win Praise; Treasuries, Junk Offerings Get Thumbs-Down*, INV. NEWS, Feb. 1, 2009.

131. See Jody Shenn, *Moody’s May Lower \$402 Billion of Subprime-Loan Debt*, BLOOMBERG, Feb. 26, 2009, <http://www.bloomberg.com/apps/news?pid=20601103&sid=agQpgFBepZFw>.

132. In a July 2007 letter informing investors in Bear Stearns’ High Grade Fund there was “very little value left” of net investor contributions totaling \$1.08 billion since the fund’s inception in 2003, the firm said “[t]he Funds’ reported performance, in part, reflects the unprecedented declines in the valuations of a number of highly-rated (AA and AAA) securities.” The SEC alleges, in a June 2008 complaint against the fund’s managers, “the undisclosed characteristics of many of the AAA/AA securities that the funds invested in rendered them fundamentally more likely to default than typical AAA/AA securities.” The SEC also cites “a private e-mail” in which the fund manager allegedly “acknowledged that certain types of AAA CDOs held by the funds were ‘not really AAA’” because the subordination structure of the underlying loans subjected the CDOs to a heightened risk of defaults. Letter from Bear, Stearns & Co., to Clients (July

The CRAs took the position that the bundled MBS were a statistical problem, not requiring analysis of the underlying instruments.¹³³ The bundled mortgages were rated based upon historical default performance. Even if the bundle included only subprime mortgages, or liar's loans, the individual mortgages were not evaluated. In what became a massive rating of bundled mortgages – generating huge profits and keeping voracious issuers happy – investors were misled to a degree not previously seen.¹³⁴

Similarly, the CRAs were evaluating the ABS, not the mortgages in the bundle of securities. These ABS were comprised of the mortgages owned by a SPE. The SPE would create financing by issuing bonds. The CRA would evaluate whether the mortgage payments from the mortgagors coming into the SPE were sufficient to allow the payments required to the bondholders. The SPE would issue 12 classes of bonds, rated from AAA to Ba1. These classes were called tranches. Highest rated bonds had first priority on mortgage payments, and priorities would follow down the lowest rated bonds. Because of these bond tiers, CRAs felt comfortable rating the top tier bonds as AAA.¹³⁵

Using mathematical models, investment banks were careful to issue bonds which met the required standards for AAA ratings.¹³⁶ CRAs, which rate investment grade securities, cut corners and provided an easy mechanism for selling the packaged securities.¹³⁷ They ignored the fact that subprime mortgages default at a much higher rate than corporate investment grade securities¹³⁸ and rated these two investments as equals. This was very misleading to investors. There was a disconnect between the true risk involved with these mortgages and the risks adequately disclosed to investors.¹³⁹ As long as the home values increased and

19, 2007) (on file with author), available at <http://www.telegraph.co.uk/finance/2812345/Bear-Stearns-letter-sent-to-investors-last-night.html> (outlining fund's history and alleging fraud); Complaint at 8-12, SEC v. Cioffi, No. 08 CV 2457 (E.D.N.Y. June 19, 2008) (on file with author).

133. See Lowenstein, *supra* note 9.

134. See SEC SUMMARY REPORT, *supra* note 120.

135. See Lowenstein, *supra* note 9.

136. See Lucchetti & Ng, *supra* note 105.

137. Robert S. England, *Industry Trends: Building a Bubble*, 69 MORTGAGE BANKING 48 (Nov. 1, 2008), available at <http://www.robertstoweengland.com/documents/MBM.England.Bubble.11-08Factiva.pdf>.

138. See, e.g., Cynthia Koons & Marine Cole, *Is Investment Grade Trading Places?*, WALL ST. J., Dec. 21, 2006, at C5; see Lucchetti & Ng, *supra* note 105.

139. See Complaint at 15-16, SEC v. Cioffi, No. 08 CV 2457 (E.D.N.Y. June 19,

defaults were minimal, no one was suffering. The CRAs have now admitted that their method of rating MBS, based upon incorrect assumptions, “did not work.”¹⁴⁰ CRAs, however, are exempt from liability for any inappropriate rating of a security.¹⁴¹

The CRAs are dominated by three agencies: Moody’s, Standard & Poor’s and Fitch.¹⁴² During the subprime mortgage boom, Moody’s earnings grew by 900% and its stock price soared by 600%.¹⁴³ Structured finance accounted for nearly 47 percent of Moody’s 2006 revenues.¹⁴⁴ These CRAs were being paid by the investment bankers they were supposed to watching. This created a direct conflict of interest.¹⁴⁵

On September 29, 2006, the Credit Rating Agency Reform Act was enacted,¹⁴⁶ amending the registration requirements for CRAs and providing for new reporting and record keeping requirements. On June 16, 2008, the SEC issued proposed regulations,¹⁴⁷ which include several new requirements for the CRAs:

2008) (on file with author).

140. *Hearing*, *supra* note 31, at 3 (statement of Deven Sharma, President, Standard and Poor’s).

141. 17 C.F.R. § 230.436(g)(1) (exempting “the security rating assigned . . . by a nationally recognized statistical rating organization” from the provisions of the Securities Act of 1933); Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (1933). See Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers* 30-32, available at http://www.tcf.or.jp/data/20050928_Frank_Partnoy.pdf; Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective* 5-6 (Council of Institutional Investors white paper, April 2009), available at <http://www.cii.org/UserFiles/file/CRAWhitePaper04-14-09.pdf>.

142. See, e.g., Sudip Kar-Gupta, *SEC Probing Main Credit Rating Agencies*, REUTERS, May 26, 2008, available at <http://www.reuters.com/article/businessNews/idUSL2619694120080526?feedType=RSS&feedName=businessNews>.

143. See Lowenstein, *supra* note 9.

144. Greg Farrell, *Credit-Rating Agencies Feel Heat*, USA TODAY, Aug. 13, 2007, available at http://www.usatoday.com/money/economy/2007-08-12-crunch-rating_n.htm (“Moody’s and S&P generate almost 50% of their revenue from deals where they’re paid by the investment banks for their ratings – a category of business known as ‘structured finance.’”).

145. See *Hearing*, *supra* note 31, at 4 (testimony of Jerome Fons, Economist and Managing Director, Moody’s); Partnoy, *supra* note 123 (adding criticism of the CRAs practice of issuing unsolicited ratings and marketing of ancillary consulting services related to ratings); Arthur Pinto, *Control and Responsibilities of Credit Rating Agencies in the United States*, 54 AM. J. COMP. L. 341, 345 (2006).

146. Credit Rating Agency Reform Act Of 2006, Pub. L. No. 291, 120 Stat. 1327 (2006) (codified as amended at 15 U.S.C. § 78o-7).

147. Rules for Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg.

- (1) A CRA can only issue a rating on a structured product if the information on the underlying product is available;
- (2) A CRA must make all of its ratings and subsequent ratings actions publicly available;
- (3) Any person participating in a credit rating decision is prohibited from negotiating the fee that the issuer pays; and
- (4) Gifts in excess of \$25 from any issuer are prohibited.

J. Bank Regulators

Banks and mortgage companies are expected to be held to some minimum standard of conduct by either the state or the federal government. This part of the equation fell apart during the last few years. No one stepped in to restrict the risky loans being made to borrowers. Although the Federal Reserve Board claimed it did not have authority to regulate these loans, it finally proposed regulations to set lending guidelines in December 2007.¹⁴⁸ For a number of years, despite growing criticism, the Federal Reserve chose a hands-off policy when it came to regulating the new breed of mortgage lender.¹⁴⁹ Of 2002 subprime loans, only 45 percent originated at banks subject to compliance exams every three years; an additional 43 percent were originated at affiliates of financial holding companies, loans which the Fed had the authority to review “for compliance with lending laws, though on a less thorough and less timely basis.”¹⁵⁰ In addition, the federal government took steps to invoke federal authority to invalidate attempts by some states to regu-

36,212, 36,227-78, 36,233-34 (proposed June 16, 2008) (to be codified at 17 C.F.R. pts. 240 & 249b).

148. See Truth in Lending Act, 73 Fed. Reg. 44,522-01, 44,528-31 (July 30, 2008).

149. On December 29, 2005, a proposed Interagency guidance was published by the Board of Governors of the Federal Reserve Bank, The Office of the Comptroller of Currency, The Federal Deposit Insurance Corporation, the Office of Thrift Supervision and the National Credit Union Administration. The Proposed Regulations outlined guidance for nontraditional lending. Interagency Guidance on Nontraditional Mortgage Products, 70 Fed. Reg. 77,249 (proposed Dec. 29, 2005).

150. The independent mortgage companies, which issued the remaining 12 percent of 2002 subprime mortgage loans, were not systematically examined at all, though they were subject to the jurisdiction of the Federal Trade Commission. Edward M. Gramlich, Governor, Fed. Reserve Bd., Subprime Mortgage Lending: Benefits, Costs, and Challenges, Remarks at the Financial Services Roundtable Annual Housing Policy Meeting, Chicago, Illinois (May 21, 2004), available at <http://www.federalreserve.gov/boarddocs/speeches/2004/20040521/default.htm>.

late these mortgages.¹⁵¹ Only when the default rates soared did the Federal Reserve issue regulations to rein in some of the more egregious borrowing practices.¹⁵² The Federal Reserve has always taken the position that asset bubbles are outside their domain.¹⁵³

The government received extensive warnings concerning the subprime mortgage market. It chose largely to ignore them. The banks which were profiting from the issuance of the poor mortgages were employing significant lobbying efforts to keep regulators away from their pot of gold.¹⁵⁴

As mortgages began to default, investors who had bought MBSs quickly began to sell them. When the MBS market eventually collapsed, some MBSs had no worth whatsoever. Investment banks, hedge funds, pension funds and even municipal governments were left with securities that could not be sold. This led to the collapse or near collapse of a number of banks. As the next Part will explore, the government, the U.S. Treasury Department, and the Federal Reserve acted

151. See Christopher L. Peterson, *Federalism And Predatory Lending: Unmasking The Deregulatory Agenda*, 78 TEMP. L. REV. 1, 86-87 (Spring 2005) (characterizing preemption language used to by Rep. Bob Ney, sponsor of the failed "Responsible Lending Act", as the unequivocal elimination of state mortgage lending law). 2001 reforms that barred banks from lending "to borrowers who do not demonstrate the capacity to repay the loan" explicitly excluded the state-regulated finance companies and mortgage brokers that originated the majority of subprime loans. In 2000, Federal Reserve Board Chairman Alan Greenspan rejected then-Fed governor Edward Gramlich's informal proposal to examine the lending practices of bank mortgage affiliates. In 2002, Greenspan rejected calls from Democrats to use the Fed's power under the Federal Trade Act to write rules on unfair and deceptive practices. Greg Ip et al., *Housing Bust Fuels Blame Game*, WALL ST. J., Mar. 19, 2008, at A1.

152. See *infra* Part V.B.3.

153. See *A Short History of Modern Finance: Link by Link*, THE ECONOMIST, Oct. 18, 2008, available at http://www.economist.com/displaystory.cfm?story_id=12415730. See generally Adam S. Posen, *Why Central Banks Should Not Burst Bubbles*, 9 INT'L FIN. 1, pp. 109-24 (Spring 2006). *Contra*, Nouriel Roubini, *Why Central Banks Should Burst Bubbles*, 9 INT'L FIN. 1, pp. 87-107 (Spring 2006).

154. Matt Appuzzo, *They Warned Us, But U.S. Eased Loan Rules*, ASSOCIATED PRESS, Dec. 1, 2008, available at <http://abcnews.go.com/Business/wireStory?id=6364464>. The home loan president of Washington Mutual, one of the biggest issuers of subprime mortgages told federal regulators in early 2006 "these mortgages have been considered more safe and sound for portfolio lenders than many fixed rate mortgages." *Id.* Within two years, Washington Mutual became the largest bank failure in U.S. history.

quickly to try to stem the damage to the nation's confidence and to its banking system.

IV. THE LEGISLATIVE AND REGULATORY RESPONSES

Many people have argued that the Federal Reserve should have acted to deflate the housing bubble. While Chairman Ben Bernanke has stated that the Federal Reserve should stay away from asset bubbles – a course they have followed throughout their history¹⁵⁵ – some argue that the Federal Reserve should at least identify asset bubbles and possibly address them during formation to limit the ultimate damage to the economy when the resulting bubble collapses.¹⁵⁶ Some elected officials believe that the Federal Reserve should have tightened lending restrictions and imposed some regulation on the new breed of lenders.¹⁵⁷ This could have at least softened the damage from the subprime debacle.

A. Existing Regulatory Schemes

*1. Truth in Lending Act ("TILA")*¹⁵⁸

TILA is a consumer credit law that was designed to protect consumers by requiring disclosures in credit transactions. It imposes limits on mortgage interest rates, but at a level which did not deter high rates on subprime mortgages. TILA requires that a lender give the borrower full disclosure of all fees. It allows for damages, but does not

155. Benjamin S. Bernanke, Governor, Fed. Reserve Bd., Asset-Price "Bubbles" and Monetary Policy, Remarks Before the New York Chapter of the National Association for Business Economics, New York, New York (Oct. 15, 2002), available at <http://www.federalreserve.gov/BoardDocs/Speeches/2002/20021015/default.htm>.

156. See *id.*; see also Frank Partnoy, *Why Markets Crash and What Law Can Do About It*, 61 U. PITT. L. REV. 741, 802-03 (2000).

157. Senator Charles Schumer (D-NY) introduced legislation on March 28, 2007 to create an agency to oversee mortgage brokers. Some states are also planning legislation. Under the proposal, a federal regulator would regulate mortgage brokers and all other non-bank lenders who currently fall outside federal oversight. The bill would also get rid of what are called "liar loans", in which income and values are doctored to allow a consumer to buy a home they cannot afford. Borrower's Protection Act of 2007, S. 1299, 110th Cong. (2007).

158. 15 U.S.C. § 1601 (1968). The interest ceiling on mortgages is set at 8% over the current comparable U.S. Treasury Note rate. 12 C.F.R. § 226.32(a)(1)(i) (2008).

allow a borrower to rescind the mortgage if the disclosure was inadequate.

However, this law had little effect on borrowers decision-making: the documents provided to the borrowers were simply too complex. Many mortgages – especially ARMs and balloon payment mortgages – are difficult for a lay person to understand without additional explanation.

2. *Home Ownership and Equity Protection Act (“HOEPA”)*¹⁵⁹

HOEPA was passed in 1994 and gave the Federal Reserve the authority to regulate home mortgages, specifically high rate, high fee mortgages. It amended the TILA to cover first lien loans and certain high rate second lien loans. The HOEPA limited closing fees and points, required full disclosure of the loan’s interest rate, and required written notice of all fees and costs by three days before the closing date. It also banned prepayment penalties, balloon payments, and due on demand loans.¹⁶⁰ However, the Federal Reserve did not implement these tools and did not issue regulations to enforce this Act until 2008.¹⁶¹

3. *Real Estate Settlement Practices Act (“RESPA”)*¹⁶²

RESPA, enacted in 1974, requires certain disclosure requirements for lenders in a residential transaction. These disclosures include: (1) a special information booklet; a good faith estimate of charges; (2) the actual settlement costs known on the day before the transaction is completed; (3) actual settlement costs; and (5) escrow payments scheduled for the first year of the mortgage.

These estimates are usually inaccurate and can confuse even an experienced buyer. The need for better disclosure requirements to borrowers remains.

159. 15 U.S.C. § 1601 et seq.

160. *See infra* V.B.3.

161. *See infra* Part IV.B.3.

162. 12 U.S.C. §§ 2601-17 (1974).

4. *Equal Credit Opportunity Act (“ECOA”)*¹⁶³

ECOA prohibits a creditor from discriminating against credit applicants on the basis of race, color, religion, national origin, sex, marital status, age, or because an applicant receives income from a public assistance program.

5. *Fair Credit Reporting Act (“FCRA”)*¹⁶⁴

FCRA protects consumers from incorrect information in their credit files held by CRAs. FCRA allows individuals to challenge the information in their credit history and to access their file once a year at no cost.

6. *Credit Rating Agency Reform Act of 2006 (“CRARA”)*¹⁶⁵

CRARA requires the registration of CRAs with the SEC.¹⁶⁶ It also requires regulation of the CRAs by the SEC and mandates that CRAs must develop rules to avoid conflicts of interest.¹⁶⁷ CRARA prohibits certain practices by the CRAs, including:

- (a) “[C]onditioning or threatening to condition the issuance of a credit rating on the purchase by the obligor or an affiliate thereof of other services or products, including pre-credit rating assessment products”,¹⁶⁸
- (b) “[L]owering or threatening to lower a credit rating on, or refusing to rate, securities or money market instruments issued by an asset pool or as any part of any asset-backed or mortgage backed securities transaction, unless a portion of the assets within such pool or part of such transaction also is rated” by the CRA;¹⁶⁹
- (c) “[M]odifying or threatening to modify a credit rating or otherwise departing from its adopted systematic proce-

163. 15 U.S.C. § 1691 (1991).

164. *Id.* § 1681 (2003).

165. *Id.* § 78o-7 (2009).

166. *Id.* § 78o-7(a).

167. *Id.* The SEC is given the authority to issue final rules concerning disclosure and conflicts of interest. *Id.* § 78o-7(c)(1)(h).

168. *Id.* § 78o-7(i)(1)(A).

169. *Id.* § 78o-7(i)(1)(B).

dures and methodologies in determining credit ratings, based on whether the obligor . . . will purchase the credit rating or any other service or product” of the CRA.¹⁷⁰

Each CRA is directed to appoint a compliance officer to administer policies and procedures to ensure compliance with securities laws.¹⁷¹

The unthinkable calamities resulting from faulty ratings of MBSs and Collateral Debt Obligations (“CDOs”) issued after 2006 have proven beyond any rational doubt that CRARA is insufficient to properly control the actions of the CRAs. The CRAs must be held responsible for their ratings and must be held liable for ratings that mislead investors. The CRAs’ practice of not reviewing the underlying securities in packages of MBSs and of relying upon statistical analysis misled thousands of investors into investments that did not undergo the proper risk analysis. The exemption of these CRAs from investor liability must be carefully reviewed and amended to better allocate responsibility and to require that CRAs complete proper due diligence before issuing a rating. As the next Part illustrates, the federal government’s legislative and regulatory responses to date have completely failed to take any steps in aligning CRAs’ interests with those investors who rely on the CRAs’ ratings. The CRAs continue to make the decisions with impunity.¹⁷²

B. Legislative and Regulatory Responses

1. Mortgage Forgiveness Debt Relief Act

In December 2007, President Bush signed into law the Mortgage Forgiveness Debt Relief Act of 2007.¹⁷³ This Act provides some relief for people who took out adjustable rate mortgages and other mortgages they couldn’t afford.¹⁷⁴ The ultimate effect is expected to be very limited. Prior to this Act, if a lender forgave debt of a mortgagor, the amount of forgiven debt was treated as gross income by the Internal Revenue Service (“IRS”) and was subject to taxation.¹⁷⁵ In an attempt to encourage workouts between mortgagees and mortgagors, the Act specifies that forgiven indebtedness from a mortgage on a personal residence is no longer taxable income.¹⁷⁶ When a property is in foreclosure, or is about to go into foreclosure, it is better for both the borrower and

170. *Id.* § 78o-7(i)(1)(C).

171. *Id.* § 78o-7(j).

172. *See* Partnoy, *supra* note 141.

lender to try to sell that property to a third party. If the sale price is less than the mortgage, the lender must “forgive” the balance of the mortgage in order to complete the sale.¹⁷⁷

2. Freeze in “Teaser Rates”

Beginning in late 2007, the Bush administration announced that lenders would freeze low “teaser rates” on adjustable rate mortgages.¹⁷⁸ Under this freeze, the initial low interest rate must remain in effect for a period longer than the contracted period. However, this would only apply to borrowers who are current on their payments and cannot afford payment increases. The then-Secretary of Treasury, Henry Paulson, has urged both lenders and borrowers of subprime mortgages to aggressively pursue the modification of loans.¹⁷⁹ Although this is a strong suggestion, it has no import of law.¹⁸⁰ Mortgage holders are separated into the following groups:

- (a) Borrowers who can afford to pay the higher rates on their adjusting mortgage;

173. Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142, 121 Stat. 1803 (2007).

174. *Id.*

175. This income is income from forgiveness of indebtedness, measured by the difference between the home’s value and the mortgage balance.

176. I.R.C. § 108 (h) (added by the Mortgage Forgiveness Debt Relief Act, 121 Stat. 1803).

177. This transaction is called a “short sale”.

A ‘short sale’ occurs when a property is sold for less than the amount owed by the borrower. A short sale can only occur with the lender’s approval. A short sale typically gets approval before a foreclosure if the lender thinks it will save money by agreeing to the short sale rather than having to go through the foreclosure process.

Karen Oakes, *What Is a “Short Sale”?*, MORTGAGE L. NETWORK, Jan. 5, 2008, <http://www.mortgagelawnetwork.com/what-is-a-short-sale/>.

178. Edmund Andrews, *Rate Freeze Said to Offer Limited Aid*, N.Y. TIMES, Dec. 4, 2007, at C1.

179. Sheila Bair, the Head of the FDIC has urged a plan which would allow modification of loans, with the borrower being limited in monthly payments to 31% of their gross monthly income and providing that the government would share in the losses of the borrower who had modified defaults anyway. See Tami Luhby, *Bill Embraces FDIC Loan Modification Plan*, CNNMONEY.COM, Dec. 10, 2008, http://money.cnn.com/2008/12/10/news/economy/waters_loan_mods/?postversion=2008121013.

180. Legislation was introduced into the House of Representatives on December 10, 2008, to allow for the modification program. *Id.*

- (b) Borrowers who are in homes they cannot afford; and
- (c) Borrowers who could afford their homes, but not at the adjusted rates.¹⁸¹

This Treasury suggestion has no benefit for those who can afford their mortgage payments or who clearly cannot afford the home – groups (a) and (b).¹⁸² It only impacts those borrowers who have the financial means, but are struggling to pay higher adjusted rates. This group can have their mortgage rate frozen at the lower “teaser rate” for up to five years.¹⁸³ Lenders have objected to this plan, claiming that it unfairly relieves people of their contractual duties.¹⁸⁴ The Treasury Department, however, believes that by saving the high cost of a foreclosure action, both parties to the mortgage will ultimately benefit from the program, since increased foreclosures further depress the value of housing and lenders then receive lower prices for the foreclosed properties.

3. Federal Reserve Regulations

By July 14, 2008, the Federal Reserve finally acted by announcing its issuance of Final Regulations, Regulation Z, pursuant to the authority given by HOEPA.¹⁸⁵ The regulations offer protection for what is termed “higher priced mortgage loans”.¹⁸⁶ These protections include:

- (1) The lender must consider the borrower’s ability to repay the loan from income and assets other than the home’s

181. Henry M. Paulson, Jr., Sec’y of the U. S. Treasury, Actions Taken and Actions Needed in U.S. Mortgage Markets, Remarks at the Office of Thrift Supervision National Housing Forum (Dec. 3, 2008).

182. *Id.*

183. *Id.*

184. See James R. Hagerty & Lingling Wei, *The Housing Plan: Pressure to Rework Mortgages Will Ripple Through Industry*, WALL ST. J., Feb. 19, 2009, at A4; Renae Merle, *New Model Is Forged In Bank’s Wreckage; U.S. Reworking IndyMac Mortgages By the Thousands*, WASH. POST, Nov. 1, 2008, at A1.

185. Truth in Lending Act, 73 Fed. Reg. 44,522-01, 44,529-31 (July 30, 2008). The final rule is effective on October 1, 2009, except for 12 C.F.R. § 226.35(b)(3), which is effective on April 1, 2010. *Id.* at 44,598. The following references cite to this final rule.

186. 12 C.F.R. § 226.35 (2008) (defining a “higher-priced mortgage loan” as a loan secured by the consumer’s principal dwelling with an APR in excess of the average prime offer rate for a comparable transaction by over 1.5, in the case of a first mortgage, and 3.5, in the case of a subordinate lien on the property, percentage points).

value.¹⁸⁷ In computing the ability to pay, the lender must use the highest scheduled payment in the first seven years of the loan;¹⁸⁸

- (2) A creditor must verify the income and assets which are relied upon to determine repayment ability;¹⁸⁹ and
- (3) Prepayment penalties are prohibited if the payment can change any time during the first four years of the loan. For other higher priced loans, the prepayment penalty must expire after two years.¹⁹⁰

Lenders must also establish escrow accounts for property taxes and homeowner's insurance for all first lien mortgages.¹⁹¹

The regulations target "high priced" mortgage loans secured by a person's principal residence. They provide four specific protections for borrowers:

- (1) Creditors are prohibited from engaging in a pattern or practice of extending credit without considering borrowers' ability to repay the loan;¹⁹²

187. *Id.* § 226.34(a)(4). The Fed reasoned "borrowers cannot reasonably avoid injuries from lenders' disregard of repayment ability" because borrowers' own assessment of their repayment ability may be influenced by their belief that a lender would not provide credit to a consumer who did not have the capacity to repay, subprime customers will accept loans knowing they may have difficulty affording the payments because they reasonably believe a more affordable loan will not be available to them and consumers are often urged to overstate their income or assets with the encouragement of a loan originator who makes it clear that the consumer's actual income or assets are not high enough to qualify them for the loans they seek. Truth in Lending Act, 73 Fed. Reg. at 44,542.

188. 12 C.F.R. § 226.34 (a)(4)(iii)(B).

189. *Id.* § 226.34 (a)(4)(ii)(A) (requiring verification of expected income or assets, by the consumer's Internal Revenue Service Form W-2, tax returns, payroll receipts, financial institution records, or other third-party documents that provide reasonably reliable evidence of the consumer's income or assets).

190. *Id.* § 226.35(b)(2).

191. *Id.* § 226.35(b)(3)(i). Escrow is not required if the collateral on the loan secured by the principal residence is a co-op. *Id.* § 226.35(b)(3)(ii)(A). Where a condominium association has an obligation to the condominium unit owners to maintain a master policy insuring condominium units, the escrow requirements do not apply. *Id.* § 226.35(b)(3)(ii)(B).

192. *Id.* § 226.34(a)(4).

- (2) Creditors would be required to verify the income and assets they rely upon in making the loan;¹⁹³
- (3) If a consumer's payment can change during the first four years following consummation of the mortgage, prepayment penalties are prohibited outright. If the payment is fixed for four years, any prepayment penalty period is limited to two years;¹⁹⁴ and
- (4) Creditors must establish escrow accounts for taxes and insurance.¹⁹⁵

These "high priced" loans apply to subprime mortgages, but do not affect conforming mortgages.¹⁹⁶

The Federal Reserve Board has also proposed additional restrictions, which would apply the following rules:

- Lenders could not compensate mortgage brokers for selling "yield spread" mortgages to the borrower, unless the borrower has previously agreed to such compensation.¹⁹⁷ These "yield spread" payments are fees generated by higher priced mortgages;
- Creditors and mortgages brokers would be prohibited from coercing an appraiser while the appraiser performs the appraisal;¹⁹⁸
- Mortgage servicing companies would be subject to a number of restrictions.¹⁹⁹ For example, the servicer must credit any payment on the day it is received, and must provide the borrower with a schedule of fees; and

193. *Id.* § 226.34(a)(4)(ii)(A).

194. Truth in Lending Act, 73 Fed. Reg. 44,522-01, 44,551 (July 30, 2008) (rejecting a proposed rule requiring a prepayment penalty provision to expire at least sixty days before the first date on which a periodic payment amount may increase under the loan's terms as moot under the more restrictive 12 C.F.R. § 226.35(b)(2)).

195. 12 C.F.R. § 226.35.

196. By its terms, 12 C.F.R. § 226.35 only applies to "higher-priced" mortgages as defined within 12 C.F.R. § 226.35(a).

197. Truth in Lending Act, 73 Fed. Reg. at 44,563 (to be codified at 12 C.F.R. § 226.36(a)).

198. 12 C.F.R. § 226.36(b).

199. *Id.* § 226.36(c).

- Creditors would be required to give the borrower a good faith estimate of closing costs within three days of the application for the loan.²⁰⁰

Nevertheless, while these regulatory changes are certainly welcome for future borrowers, questions remain as to why the Fed did not take these steps earlier.

C. Troubled Asset Relief Program ("TARP")

In response to a meltdown of the international credit market, on October 3, 2008, President Bush signed into law the Emergency Economic Stabilization Act (the "Stabilization Act"), giving the Secretary of the Treasury (the "Secretary"), through a newly created office, "The Office of Financial Stability", power to help restore value to troubled assets by either purchasing these assets or guaranteeing them.²⁰¹ Through TARP, which is included in the Stabilization Act, the Secretary may use up to \$700 Billion to purchase distressed assets and to manage, workout, finance and repackage those distressed assets, mainly MBSs, which had severely diminished in value.²⁰²

I. Troubled Assets

"Troubled Assets" are defined as "residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages."²⁰³ The Stabilization Act only applies to Troubled Assets issued before March 14, 2008.²⁰⁴ However, the

200. *Id.* § 226.19.

201. 12 U.S.C. §§ 5211, 5212.

202. 12 U.S.C. § 5211. "The assets affected under the government plan are largely loans and securities backed by residential and commercial real estate. Such assets have been devastated by the meltdown of the housing markets and have started coming under even greater strain in recent weeks as the U.S. economy slows." David Enrich et al., *U.S. Agrees to Rescue Struggling Citigroup*, WALL ST. J., Nov. 24, 2008, at A1. As originally conceived, mortgage assets were one of many troubled assets at the heart of a complex TARP program. Andy Kessler, *What Paulson Is Trying to Do*, WALL ST. J., Oct. 15, 2008, at A19. Paulson soon broadened TARP's scope and shifted its focus. Deborah Solomon, *Bailout's Next Phase: Consumers – Paulson Quits Plan to Buy Bad Assets; Focus on Credit Cards, Car and Student Loans*, WALL ST. J., Nov. 13, 2008, at A1.

203. 12 U.S.C. § 5202(9)(A).

204. *Id.*

Secretary has authority to determine that other assets may be purchased if the purchase “is necessary to promote financial market stability.”²⁰⁵ The instruments which may be purchased thus include: Alt-A mortgages, subprime mortgages, and prime residential mortgages; MBSs and CDOs; syndicated commercial mortgages; and other mortgage related derivatives.²⁰⁶

2. *Eligible Financial Institutions*

The Secretary is allowed to purchase Troubled Assets from a financial institution “established and regulated under the laws of the United States or any State.”²⁰⁷ The financial institution must have “significant operations within the United States.”²⁰⁸ Excluded are “any central bank or institution owned by a foreign government,”²⁰⁹ as well as privately owned hedge funds, Real Estate Investment Trusts (“REITs”) and other conduit entities.

3. *Limits on TARP*

The general limit on purchased troubled assets is \$250 billion, and the program is set to end on December 31, 2009.²¹⁰ However, the Secretary and Congress may expand the program to a maximum of \$700 billion, and extend it to October 3, 2010.²¹¹

4. *Pricing of Troubled Assets*

The Secretary is authorized to purchase Troubled Assets in a manner which will “minimize any potential long-term negative impact on the taxpayer.”²¹² This provision was intended to give the Secretary wide latitude in choosing how to price and purchase Troubled Assets. Issues to consider when pricing and purchasing Troubled Assets include the long-term return on the asset and the benefits to the overall econ-

205. *Id.*

206. *See id.* § 5202(9)(B).

207. *Id.* § 5202(5).

208. *Id.*

209. *Id.*

210. *Id.* § 5225.

211. *Id.*

212. *Id.* § 5223(a)(1).

omy.²¹³ Direct purchases of assets from individual institutions are allowed, but prices paid must be “reasonable and reflect the underlying value of the asset.”²¹⁴ The assets may also be purchased at auctions, which would better ensure a fair price is paid.

The pricing of the troubled assets will be the main problem in implementing the program. Although current market values are low and the purpose of the program is to quickly benefit institutions saddled with devalued assets, it is imperative that the price is set at a fair value. Otherwise, the Treasury Department will eventually face losses on the purchase of these assets. If properly implemented, the program can help to provide funds for cash strapped institutions while allowing the government to buy assets at low prices, and either receive profits from the ultimate sale of the assets or from the collection of payments from the underlying mortgages. The Stabilization Act specifically allows the institutions to realize a profit on the sale of assets to the Treasury.²¹⁵

5. *Executive Compensation*

One of the many controversial aspects of TARP is the possibility that executives of the financial institutions which are being aided with taxpayer funding may use some of the proceeds to pay themselves excessive compensation, rather than use the money to increase their lending.²¹⁶ If the Fund purchases assets directly from a financial institution, the Stabilization Act provides that the Secretary has the authority to require the institution to meet “appropriate standards of executive compensation and corporate governance.”²¹⁷

6. *Management and Servicing*

As discussed above, the Secretary has broad authority to manage any assets purchased under TARP.²¹⁸ This authority includes managing the assets, revenues, and portfolios acquired by the Fund. The Secretary also has the power to create various vehicles if necessary to properly

213. *Id.*

214. *Id.* § 5223(c).

215. *Id.* § 5223(a)(2), (b).

216. Steve Lohr, *In Bailout Furor, Wall Street Pay Becomes Target for Congress*, N.Y. TIMES, Sept. 23, 2008, at A1.

217. 12 U.S.C. § 5221(b)(1).

218. *Id.* § 5216(b).

manage the assets. The Stabilization Act also encourages servicers of mortgages to use the HOPE NOW program for distressed residential mortgages.²¹⁹

At this point, however, it appears as though the government response is insufficient to prevent future recurrences of the credit meltdown. Institutional memory is only a few years. Eventually, absent effective oversight and proactive government regulation, greed and irresponsibility will act to create a new bubble. Part V of this Article will discuss the federal government's takeovers of the Government Sponsored Enterprises ("GSEs") Fannie Mae and Freddie Mac. Part VI will then discuss the lawsuits emerging as the subprime fallout grows. Finally, Part VII will discuss the critical goals new regulations must achieve to prevent a second coming of the subprime leviathan and the devastating losses and demoralizing litigation inevitably left in its wake.

V. THE TAKEOVER OF FANNIE MAE AND FREDDIE MAC

The development of the secondary mortgage market in the United States was originally designed to provide additional mortgage funding for residential homeowners.²²⁰ Before the Great Depression, it was rare that an individual could purchase his own home. During the depression many people had defaulted on their mortgages and lost their homes. There was a general lack of confidence in the mortgage system. As a result of the depression, Congress took steps to encourage home ownership and to help ensure adequate funding for prospective borrowers, thereby attempting to restore the shaken confidence in the market. Starting in 1934, mortgage insurance programs were developed in the Federal Housing Administration ("FHA").²²¹ The FHA provided loans which assured that the lender, in case of default, would be paid. In addition, the Veteran's Administration developed programs which guaranteed mortgage payments by veterans of the armed forces.²²²

219. *Id.* § 5219(a).

220. See Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2193 (2007).

221. National Homeownership Day, 1995, 60 Fed. Reg. 29,957 (1995); HUD – The Federal Housing Administration (FHA), <http://www.hud.gov/offices/hsg/fhahistory.cfm> (last visited Feb. 17, 2009).

222. "In 1944, the GI Bill of Rights set up the Veterans Administration's home loan guaranty program, enabling millions of veterans to start a new life for themselves and their families." 60 Fed. Reg. 29,957.

In 1933, Congress created the Reconstruction Finance Corporation (“RFC”).²²³ This agency engaged in many activities, but one of its most important functions was to buy FHA and Veterans Administration insured mortgages. The increased liquidity of these loans made them more attractive as an investment for purchases of mortgages. The RFC succeeded in adding money to the mortgage market by buying these loans from lenders, thereby freeing up more of the lender’s money to make new home loans. The RFC began liquidating in 1953 and dissolved in 1957.²²⁴

In 1938, Congress established the Fannie Mae as another boost to the secondary mortgage market.²²⁵ Fannie Mae’s intended purpose was to purchase new and existing mortgages from lenders. In 1968, Congress divided Fannie Mae into two parts: Fannie Mae and the Government National Mortgage Association (“Ginnie Mae”).²²⁶ In 1970, Congress created yet another agency, the Freddie Mac.²²⁷

For many years, Fannie Mae and Freddie Mac were successful in promoting a stable, successful secondary mortgage market, where many other investors also bought mortgages. Some REITs became mutual funds precisely to take advantage of the liquidity for mortgages in this secondary market.²²⁸ Fannie Mae and Freddie Mac bonds were long reputed to be excellent investments.²²⁹

223. Reconstruction Finance Corporation (Strategic Material Loan) Act, 72 Pub. L. No. 2, 47 Stat. 5 (1932) (repealed 1957).

224. Reconstruction Finance Corporation Liquidation Act, 83 Pub. L. No. 163, 67 Stat. 230 (1953) (liquidating the RFC created under 15 U.S.C.S. prec § 601 by providing for RFC’s continuation through the summer of 1954 and terminating its lending powers in the fall of 1953); Reorganization Plan No. 1 of 1957, 22 Fed. Reg. 4633, 71 Stat. 647 (1957) (abolishing the RFC and transferring remaining functions to the Housing and Home Finance Agency, General Services Administration, Small Business Administration and Commerce Department).

225. Title III of the National Housing Act, 48 Stat. 1246 (1938) (codified as amended at 12 U.S.C. § 1716 (1992)).

226. Title VIII of the Housing and Urban Development Act of 1968, 82 Stat. 503 (1968) (codified as amended at 42 U.S.C. § 3931 (1968)).

227. Emergency Home Finance Act of 1970, 12 U.S.C. § 1452 (1970).

228. See generally Sydney LeBlanc, *Non-Traded REITs: Finally passing muster*, 5(13) Broker Dealer (2007), available at <http://www.brokerdealermagazine.com/?p=95>.

229. In 1999, when President Clinton predicted “the U.S. government will be debt-free in 15 years,” the “[c]redit-market cognoscenti” speculated agency debt (Fannie, Freddie, etc.) was an “appropriate” replacement for the Treasury’s “long T-bond” as “the most representative gauge of long-term interest rates.” As Barron’s reported at the time:

At some point, the officers of these entities changed their method of operation to become more profit driven. Instead of focusing on their stated purpose and exclusively buying conforming mortgages, the entities began to engage in riskier activities. In 2003, Freddie Mac was subject to a significant accounting scandal.²³⁰ Although the Bush administration attempted to create an agency for the oversight of Fannie Mae and Freddie Mac,²³¹ a bill sanctioning the creation of such an agency did not make it out of the Senate Banking Committee.²³² The GSEs, taking on increasingly riskier investments, continued their descent into risky investment territory.

In 2007, four executives paid fines and restitution for their activities relating to accounting fraud; Freddie Mac paid \$50 Million in fines to settle claims made by the SEC.²³³ In the following year, the financial condition of both agencies deteriorated significantly as a result of investments in subprime mortgages. Fannie Mae and Freddie Mac had become institutions with tremendous influence in Congress, earned by providing campaign funds and extensive lobbying efforts. They had also become institutions which had made significant poor decisions in the pursuit of profits and increased personal compensation.²³⁴

Aware that their securities are the most obvious replacement, given their implied government guarantee, Fannie Mae, Freddie Mac and the Federal Home Loan Bank are now offering regularly scheduled auctions of longer-dated benchmark securities. Already, notes William Lloyd of Barclays Capital, agencies are being used by Wall Street dealers to hedge interest rate risk in other securities, such as corporate bonds, one of the key functions performed by Treasuries. As liquidity in the agency market [increases], these issues should become a natural surrogate for T-bonds.

William Pesek Jr., *New Deficit? Budget surplus means shortfall of Treasury bonds*, Barron's, Dec. 27, 1999, at 21.

230. See *Trouble at Home*, THE ECONOMIST, June 14, 2003. The top three executives at Freddie Mac departed abruptly after accounting irregularities were discovered during an audit. Allegations of missing documents, lavish pay and uncooperative directors surrounded the inquiry.

231. See Stephen Labaton, *New Agency Proposed to Oversee Freddie Mac and Fannie Mae*, N.Y. TIMES, Sept. 11, 2003, at C1.

232. S. 1656, 108th Cong. (2003).

233. David Hilzenrath, *Raines, Federal Regulators Reach Settlement*, WASH. POST, Apr. 20, 2008, available at http://voices.washingtonpost.com/washbizblog/2008/04/regulator_to_dismiss_charges_a.html.

234. *The Role of Fannie Mae and Freddie Mac in the Financial Crisis: Hearing Before the H. Comm. On Oversight and Government Reform*, 110th Cong. 12 (2008) (testimony of Edward Pinto, Former Chief Credit Officer of Fannie Mae), available at www.oversight.house.gov/documents/20081209145847.pdf.

On July 24, 2008, Congress passed the Housing and Economic Recovery Act of 2008 (“HERA”), which established the Federal Housing Finance Agency (“FHFA”) and expanded federal regulatory authority over the GSEs.²³⁵ HERA provided for the dismissal of current CEOs and the takeover of management and the power of the board of directors. All political activities and lobbying were terminated. A direct relationship with the U.S. Treasury will provide new financing for the agencies. The takeover of these two agencies provides an opportunity to expand their control and the regulation of the mortgage backed securities markets.

VI. LAWSUITS

Whenever a disaster occurs, lawyers and lawsuits will follow. The subprime mortgage debacle is spawning a massive wave of legal action. Class action suits are being brought against many of the players in the mortgage market.²³⁶ The securities firms that packaged and sold the mortgage backed securities are being sued.²³⁷ The banks and mortgage companies who created the mortgages are being sued.²³⁸ So are the insurers who insured the securities created with mortgages.²³⁹ Ratings agencies and homebuilders are likewise in the litigation frenzy.²⁴⁰ Pension funds that purchased the mortgage backed securities are being sued by their members. In addition, some government agencies are going after the investment banks who sold these investments.²⁴¹

The most egregious players – the mortgage banks who made the bad loans – have been subject to the greatest number of legal actions, both by individual litigants and by government agencies.²⁴² Bankruptcy

235. Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654 (2008). President Bush signed HERA into law on July 30, 2008.

236. Martha Graybow, *Class-Action Lawyers Pounce in Subprime Crisis*, REUTERS, Mar. 14, 2007, <http://www.reuters.com/article/bankingfinancial-SP-A/idUSN1426067420070314>.

237. Brian E. Robison, *Litigation in the Wake of the Subprime Lending Collapse: What Has Happened and Where We Are*, in FIRST FOCUS: THE SUBPRIME CRISIS 59, 60-61 (Skupien ed., Thomson West 2008).

238. *Id.*

239. *Id.* at 63.

240. *Id.* at 61-65.

241. *Id.* at 60-65.

242. In a report issued on February 14, 2008, Navigant Consulting said that subprime mortgage litigation in 2007 spawned 278 lawsuits, and the number was

courts have been flooded with cases that raise issues regarding mortgages.

The Attorney General of New York has begun an investigation into the information provided by investment banks concerning the quality of the loans offered in securities packages.²⁴³ Millions of dollars of mortgages were bundled for sale to investors. Many of the loans in the bundles did not meet minimum lending standards required within the pool of mortgages being purchased by investors. This was a fact which should have been disclosed. Estimates are that these poorer credit risk loans, sometimes called “exception loans,” made up as much as 80% of a bundle of securitized mortgages.²⁴⁴ These loans can be more likely to enter default than even subprime mortgages.²⁴⁵ The Attorney General has suggested that, in some cases, the investment banks did not fully disclose to investors the number of exception loans in a bundle.²⁴⁶ The specific issue is whether material information about the loans was fully disclosed to the investors and rating agencies. The disclosures in many of the documents were simply generic discussions of investment risk.

A number of cities are seeking redress from lenders for having flooded local housing markets with subprime mortgages which were unlikely to ever be repaid, thus putting entire neighborhoods at risk. For example, the City of Cleveland has sued banks and financial institutions under the state public nuisance law.²⁴⁷ It asserts that the financial institutions created a public nuisance in areas of Cleveland because their loans led to widespread abandonment of homes.

continuing to increase. Mortgage bankers were sued in 32 percent of these cases. Borrower class actions made up 43 percent of all cases. Securities cases constituted 22 percent of the cases. *Subprime Mortgage Litigation Outpacing Savings-and-Loan Crisis of the Early 1990s*, REUTERS, <http://www.reuters.com/article/pressRelease/idUS227647+14-Feb-2008+BW20080214/>.

243. Vikas Baja & Jenny Anderson, *Inquiry Focuses on Withholding of Data on Loans*, N.Y. TIMES, Jan. 16, 2008, at A1.

244. *Id.*

245. *Id.* Some of these loans were “exception loans” to a small degree, such as a failure to meet a minimum credit score. Not all exceptions were very bad loans.

246. *Id.*

247. Karen Pierog, *Cleveland Sues 21 Banks Over Mortgage Foreclosures*, REUTERS, Jan. 14, 2008, <http://www.reuters.com/article/bankingfinancial-SP/idUSN1129443220080114>.

VII. CHANGES REQUIRED

A. Consumer Counseling

Some commentators have proposed that people taking on mortgages should be counseled about the financial impact of the mortgage on their lives.²⁴⁸ Clearly, some mortgagors need independent financial advice before executing a mortgage. The problems involved in requiring this advice are in determining the people who need the advice and in determining the people who should give the advice. Regulation Z could require that a lender making a non prime mortgage must pay for borrower counseling from a non-profit mortgage counseling agency. A borrower's attorney should have the responsibility for giving financial counsel to the borrower. It would seem this should be an ethical obligation if the mortgage appears to be beyond the financial means of the borrower or has features the borrower should be warned about. The ethical requirements for attorneys involved in real estate closings should include a duty to provide financial counseling to mortgagors who will be at significant risk because of the excessive cost of the mortgage.

Counseling speculators, however, would probably not have influenced their decisions. Greed and a desire for easy profits can lead to bad decisions and a willingness to ignore any rational advice. In this context, the lender should bear any responsibility for making loans to speculators. This requires proper information relating to the mortgagor's income, ability to repay and plans for use of the mortgage proceeds. Loans used for speculative purposes need to be identified clearly through prerequisite due diligence by the lender, so that if the mortgage is to be sold, any possible purchaser of the mortgage can properly assess the risk associated with the speculative mortgage. Adequate "flagging" of the speculative loans must be required of lenders.

B. Transparency

Investment banks who package MBS must be required to disclose the quality of the mortgages within each package. Considering the fees charged and the review by attorneys of each package, it is not unreasonable for the issuer to provide adequate information about the mort-

248. See, e.g., ROBERT SHILLER, THE SUBPRIME SOLUTION 123 (2008), available at <http://press.princeton.edu/chapters/s8714.pdf>.

gages in the packages. Merely offering an opinion by a CRA is not sufficient information for an investor to make a properly informed investment decision. The mortgages must be properly graded, and the grading information included in the loan package.

C. National Registration and Grading of Securitized Mortgages

Some commentators have argued for more federal regulation of mortgage lending.²⁴⁹ More transparency is required in the securitization of mortgages. More information must be given to prospective investors. Too much reliance has been placed upon CRAs.²⁵⁰ Additionally, this system has failed terribly to fairly gauge the risks of investments. Trust must be reintroduced into the MBS market. Without that trust, the market cannot adequately perform.

Each mortgage must be properly graded and clearly labeled, with the grader holding responsibility for the grade assigned. If a lender wishes to sell a mortgage, it is important to adequately disclose the quality of that mortgage as opposed to making the mortgage without adequately evaluating the likelihood that the mortgage would be repaid. In some instances, it appears that virtually no consideration was given to whether the mortgage would be repaid. This lack of responsibility in making the mortgage stemmed from the ease with which these deficient mortgages could be sold to unwary investors. In order for confidence to be restored, investors must know what they are buying. Before a mortgage can be sold, the mortgage lender should verify certain aspects of the mortgage application, such as the borrower's credit score and income, the loan to value ratio, and the amount of the down payment. There should be no "exception loans". Each loan should be graded on a standard system; for example, a loan could be graded from A through E, based upon the likelihood of repayment. The issues involved in the grading – whether this is a primary residence, whether the credit score is somewhat deficient, the size of the down payment and whether the purchase is for investment purpose – should be reflected in the grade and should be disclosed to the purchaser of the loan. The lender should be responsible for any negligent or fraudulent information he provided.²⁵¹

249. See, e.g., Cassandra Jones Havard, "Goin' Round in Circles" . . . and Letting the Bad Loans Win, 86 NEB. L. REV. 737 (2008).

250. See Aaron Unterman, *Exporting Risk: Global Implications of the Securitization of U.S. Housing Debt*, 4 HASTINGS BUS. L.J. 77, 90-91 (2008).

251. The Mortgage Reform and Anti-Predatory Lending Act was introduced into

Part of the securitization process should be the grading and registration of loans to be sold. The information relating to the loans in a package of loans should be entered and registered on a national system, allowing prospective purchasers to clearly evaluate a proposed purchase. The process should be similar to a public offering prospectus, but should be far less onerous to issuers and simpler to produce.

D. Responsibility

Finally and most importantly, in order to regain confidence in the mortgage market and the MBS market, responsibility must attach to each decision maker. If a person will suffer the consequences of his or her decision, then the quality of the decision will improve. The MBS market created a disconnect between the decision maker and the responsibility for the decision. This must be corrected. Mortgage originators must be made responsible for the consequences of bad loans. If the loan fails to perform, the originator must suffer the consequences.

CRAs are currently exempt from liability for errors, mistakes and misstatements in their ratings process. This has caused ratings to be issued which do not reflect the true risk involved for investment in MBSs. These rating agencies must bear responsibility to the investors, not just their clients, and the investment banks. More transparency is required in how the ratings are determined. Each individual bundle needs to provide adequate information about its true risk. The number of mortgages included and the quality of those mortgages must be disclosed. Mere statistical analysis is insufficient. An investor needs more information in order to make a rational investment decision. The securities laws need to protect investors from the investment banks and the CRAs.

VIII. CONCLUSION

In order to maintain a vibrant real estate market and to encourage home ownership, it is important that mortgage securitization and the

Congress by Representative Bradley Miller, and passed the House of Representatives on November 15, 2007. The Act would establish a national Mortgage Licensing System Registry; impose a duty of care on loan originators and establish further restrictions on nonqualified mortgages. H.R. 3915, 110th Cong. (as passed by the House, Nov. 15, 2007). The Bill was referred to the Senate. As of December 9, 2008, no further action has been taken.

secondary mortgage market emerge from the present crisis intact. The MBS market has proven over many years to be a valuable source of money for long-term growth in the United States, allowing individuals to achieve their dreams of owning their own residence. It is vital this market is restored and a vibrant secondary market is reestablished. Significant changes must be made, in order to properly allocate responsibility among the various entities who participate in the market.

There are, of course, costs associated with regulation and allocating responsibility. Lenders will have to either insure their losses, maintain higher reserves or increase their lending standards. All of these alternatives will result in higher costs to lenders and borrowers. Given the incredible costs involved in cleaning up the wreckage of an unregulated market, these regulatory costs seem far more reasonable. The investment banks who sell MBSs must be required to provide adequate information to investors as to the mortgages included in the package, including whether each mortgage meets conforming standards. The securities regulators must provide adequate protection for investors by requiring that issuers adequately disclose the true risks involved with bundled mortgages. In order to reinvigorate the mortgage backed securities market, significant new rules must be implemented.